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The
Morgan Guaranty Survey

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This month's Survey *is entirely devoted to one topic: the prospects and problems facing the U.S. economy.*

- *What lies ahead for the recovery as it moves into its second year?*
- *What of secular trends that will dominate the outlook beyond 1984—inflation, wages, productivity, capital investment?*
- *And what of the larger challenges that need to be met if the 1980s are to produce sustained growth? Key among these is a federal budget that is out of control and a monetary policy that needs redefinition.*
- *Yearend review and outlook for the economy sector by sector, with detailed quarterly projections.*

The Economy in 1984—and Beyond

THE recovery, now a year old, has been both routine and surprising. With real GNP growing an estimated 6½% over the past four quarters, the pace of expansion has been roughly in line with the typical postwar experience (chart on page 2). But the economy's ability to forge ahead (actually at double the rate of last winter's consensus forecast) despite historically high interest rates and a sharp deterioration in this country's external accounts sets this recovery apart from any since the end of World War II. So does the striking shift in the composition of national income—toward profits and away from personal income. This shift will have a significant influence on capital investment and on the pace of the recovery in its second year.

The Morgan Bank projects continued cyclical advance in 1984, with real-GNP growth of about 4½%, fourth quarter to fourth quarter (table on page 2).

Against the background of major surprises in 1983, continued advance in the economy—while the most likely expectation—cannot be taken for granted. One obvious source of concern is the fragile debt condition of developing countries. Another is the policy drift in Washington on ways to narrow massive budget deficits. A further uncertainty is the still unsettled state of Federal Reserve policy.

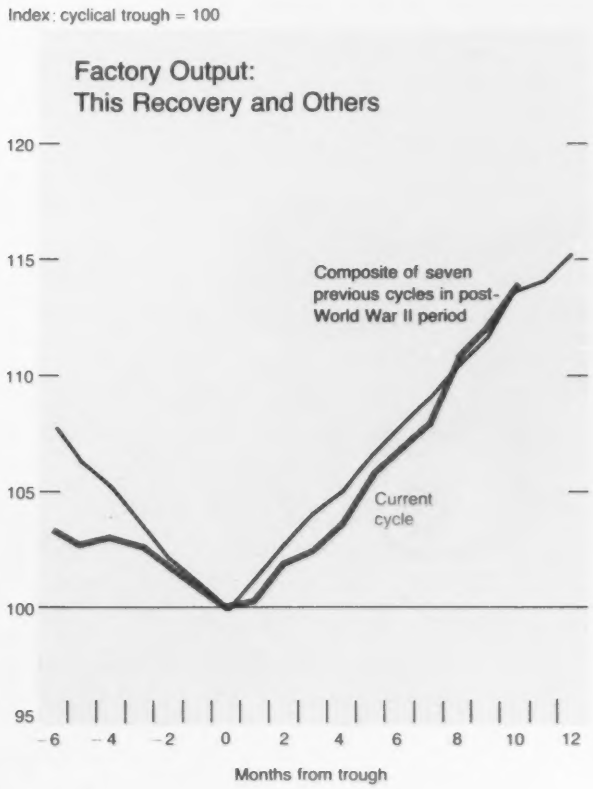
Having backed away from strict targeting procedures for monetary expansion—because of the severity of the recession—the Fed is in a much looser posture in which judgment and flexibility seem paramount. The practical considerations (including the delicate international debt situation) that argue for such a posture at this time are impressive. The consequence, how-

ever, is that no one can be sure what long-term strategy the Fed will be able to develop to consolidate and improve on inflation gains now that economic activity is expanding.

Farther down the road—1985 and beyond—the doubts and unease that cloud the outlook will not diminish unless confidence develops that policy makers have the skill, scope, and resolve to fashion an appropriate policy. For the present, the crucial question of whether the progress realized on the inflation front during the recession will prove lasting remains open.

Looking back—briefly

The vigor of the recovery caught most analysts by surprise. In retrospect, excessive attention was paid to the potentially inhibiting effects of high interest rates. There was also a tendency to forget just how powerful, at least for a time, the self-extending thrust of a cyclical upturn can be.



Note: The trough month for this cycle is November 1982

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

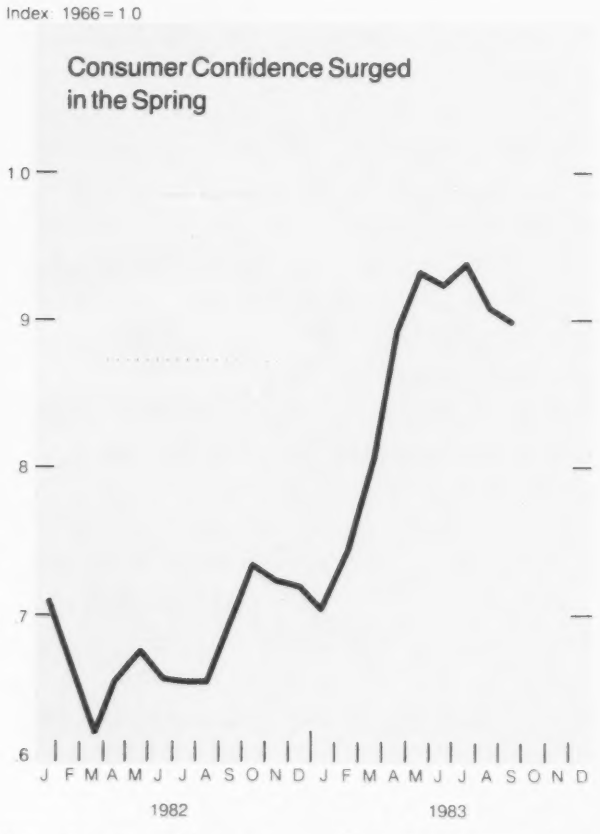
	1983	1984			
	Q4	Q1	Q2	Q3	Q4
Real GNP	5.5	4.6	4.5	4.7	4.5
Real consumer spending	5.0	4.1	2.9	3.1	2.9
Real business-capital outlays	11.9	10.0	9.3	8.6	10.0
GNP deflator	3.9	4.8	4.6	4.4	4.9
Consumer prices	4.9	4.9	4.6	4.5	4.5
Real disposable personal income	4.6	2.1	2.8	3.0	3.5
Saving rate (%)	4.6	4.2	4.2	4.1	4.2
Housing starts (Millions)	1.7	1.7	1.7	1.7	1.8
Auto sales (Millions)	9.8	10.0	10.1	10.3	10.4
Unemployment rate (%)	8.9	8.8	8.8	8.6	8.5

In the last half of 1982, accommodative Federal Reserve policy resulted in money growth well in excess of established targets and caused a sharp drop in interest rates—about six percentage points for short rates and three percentage points for long rates. Even though such declines left credit costs unprecedentedly high for the end of a recession, the declines from earlier heights helped make housing more affordable. And, in combination with a rising stock market, they produced a turnabout in the national mood.

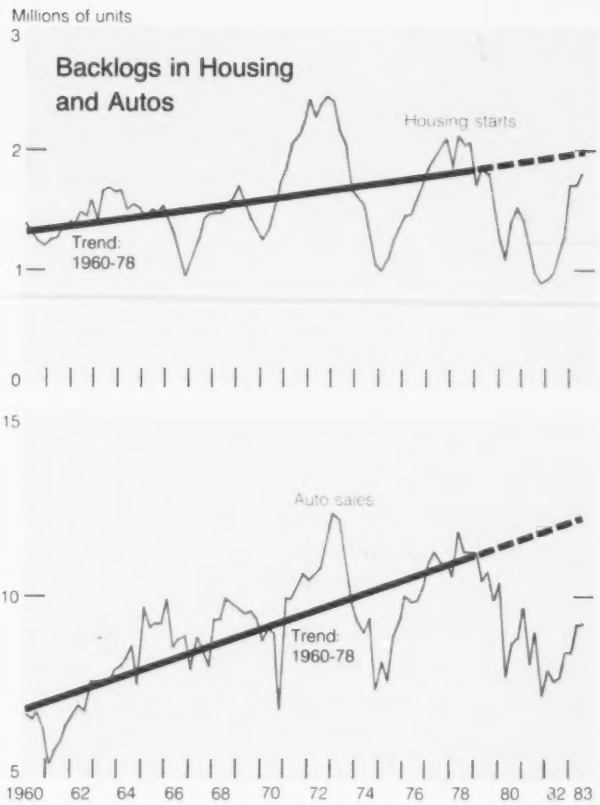
The stimulus of sharply lower interest rates in the second half of 1982 was not evident for a while because businesses remained intent on reducing inventories. Gradually, however, expan-

sion took hold in housing and autos, reinforcing the support to business sales coming from the defense buildup. By late 1982, with overall final demand rising and inventories much reduced, the stage was set for a rebound in production.

Growth in residential construction and the start of an easing of inventory liquidation pushed real GNP upward in the first quarter of 1983 and brought about the welcome surprise of a sharp drop in unemployment. Consumer sentiment rebounded, as shown in the chart below. As consumers lost their fears, recovery in housing and autos accelerated and strength in household spending broadened, producing a rise of 10% at an annual rate in real personal consumption expenditures in the second quarter—the largest quarterly gain in almost 20 years.



Note: Consumer confidence as measured by The Survey Research Center at the University of Michigan.



An important element in the household-spending surge, one that was greatly underweighted in economists' 1983 projections, was the pent-up demand that accumulated during 1980-82 when acquisitions of autos and the number of new housing units coming onto the market fell below long-term trends (accompanying chart). This pent-up demand is probably far from exhausted and is likely to remain a sustaining influence in the economy (interest-rate levels permitting) well into the future.*

*Measurement of pent-up demand is difficult, especially in the case of autos where long-term trends may have been affected significantly by "oil-shock" factors. However, the average age of the car on the road (now seven years) has moved so significantly above the norm as to suggest that car sales ought to be biased upward whenever the general economic environment is not adverse. In the case of housing, demographics suggests that when cyclical recovery began in the economy the backlog of housing demand was equivalent to as many as a million starts. That still seems to be a good working estimate of the current backlog.

Self-feeding tendencies (which recently have begun to induce a decisive recovery in business investment) have limits, of course. Certainly in 1984, dynamic cyclical forces are likely to be less powerful than they have been this year. Indeed, some downshifting in the rate of economic advance seems to be in progress. This partly reflects the rise in both short- and long-term interest rates that occurred last spring and summer when the Fed tightened reserve availability moderately and investors reacted negatively to signs that fiscal policy was stalemated.*

Among the reasons for anticipating a slower pace of advance in 1984 than in 1983:

• The inventory rebound, involving a move from sharp drawdowns late in 1982 to fairly rapid accumulation now, seems largely spent. Inventory-to-sales ratios are still low in historical perspective. But most businesses, mindful of high carrying costs, seem intent on keeping inventories as low as possible, consistent with efficient marketing. Whereas the inventory rebound has accounted for nearly 40% of the rise in real GNP over the past year, inventory behavior is likely to be an essentially neutral influence in the economy in 1984.

• Consumers are unlikely to be as active as they were in last spring's buying spree. Having let their saving rate slip to a 20-year low, consumers lack the ability they once had to increase their spending more rapidly than income growth. Household wealth remains high in an absolute sense, but further wealth increases of the size that occurred in the major runup of stock and bond prices in 1982-83 seem unlikely. With the growth of real consumer income settling down to a pace of 3% or thereabouts (reflecting moderate wage gains), that is probably the most reasonable growth rate to project for real personal consumption expenditures during 1984.

Sources of Growth During Recoveries

	Typical Cycle	*Current Cycle*
Percent of growth accounted for by:		
Consumer expenditures	51.8	53.7
Residential construction	16.5	22.1
Business investment	7.1	11.1
Net exports	−4.3	−19.4
Inventory investment	25.0	37.3
Government purchases	3.9	−4.9

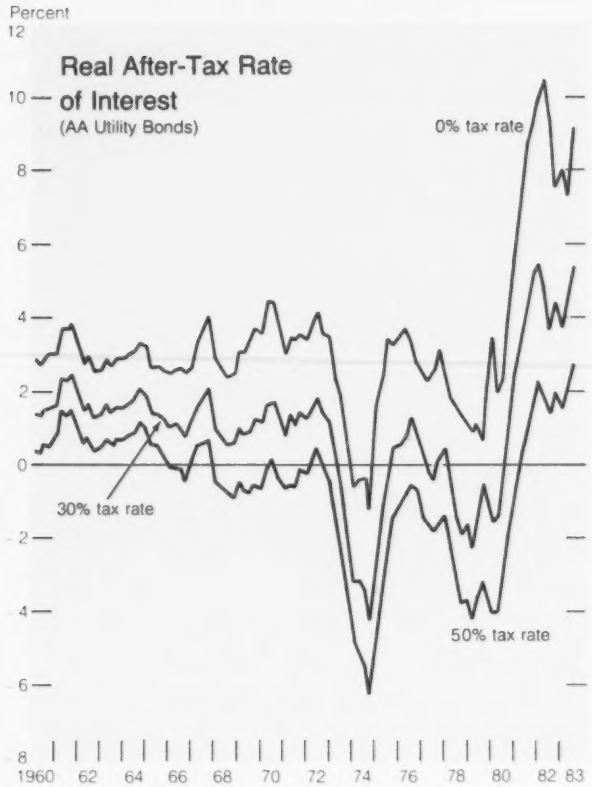
Note: Figures for the typical cycle are averages for the first three quarters of the seven previous postwar business recoveries. Figures for the current cycle are from the fourth quarter of 1982 to the third quarter of 1983.

• The loss of a lot of the earlier zip in housing is also a significant omen for the broad economy in 1984. This year, surging outlays for residential construction accounted for about one-fifth of the rise in real GNP. Next year, however, housing looms as an essentially neutral factor, with starts likely to average about 1.7 million units, the same as in 1983.

The housing outlook reflects the balancing of several conflicting forces. On the plus side, demographic factors remain favorable, as the peak of the postwar baby boom is just now entering the age categories that normally supply

*The roughly 150-basis-point rise that occurred from May to July in long rates (which, very atypically, was larger than the Fed-triggered rise in short rates) was a significant development as far as the recent performance of the economy is concerned. It quickly weakened housing activity as monthly carrying charges on a median-priced house financed with a 75% mortgage loan rose by $80 per month.

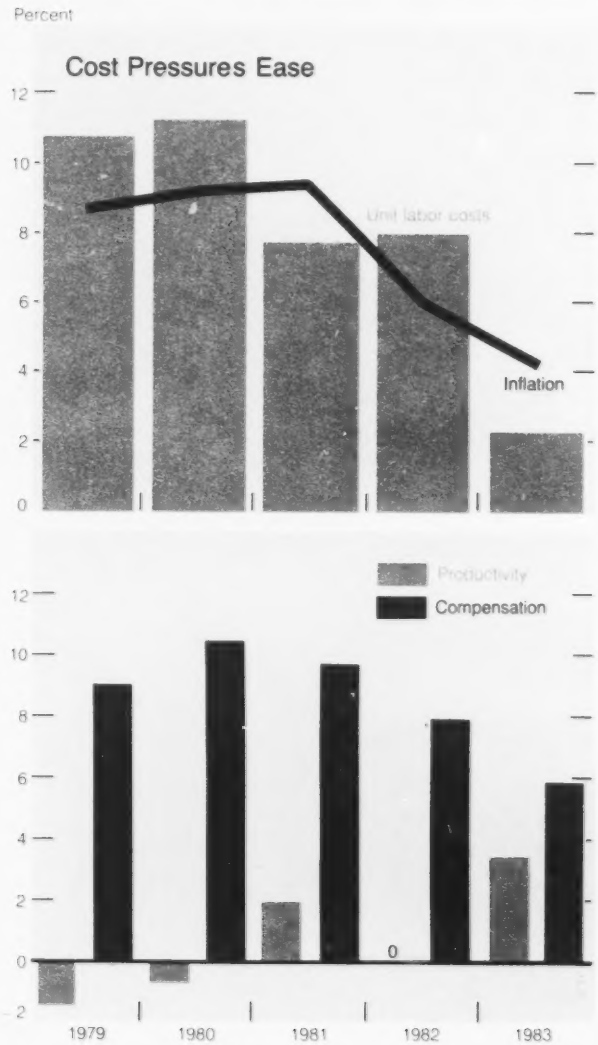
The important message in this is that the shift in Fed policy during the spring (which ordinarily would not have caused or been accompanied by anything like the change in long-term rates that took place) was not solely responsible for the downshifting of economic growth. Indeed, hints of downshifting in the economy in the last few months may very well have created a misleading impression of the conditioning influence of moderate changes in Fed policy.



Note: The four-quarter increase in the personal consumption deflator was used to calculate the real interest rate.

most first-time home buyers. Moreover, with the deregulation of deposit-gathering by financial institutions now largely complete, and with expanded secondary mortgage market mechanisms firmly in place, availability of financing is not likely to pose a serious problem. In addition, the growing popularity of adjustable-rate mortgages with lower initial carrying charges than those on fixed-rate mortgages ought to help sustain demand.* At the same time, however, costs of ownership remain high, and rising vacancy rates bode ill for a continuation of this year's unusual strength in building of rental units.

To be sure, there are offsets to the forces that will moderate the economy's growth in 1984. Most important, signs are growing that business outlays on new plant and equipment will provide strong support. This is particularly promising because profitability has been rising at an unusually fast pace, partly reflecting the pronounced shift in income away from personal in-

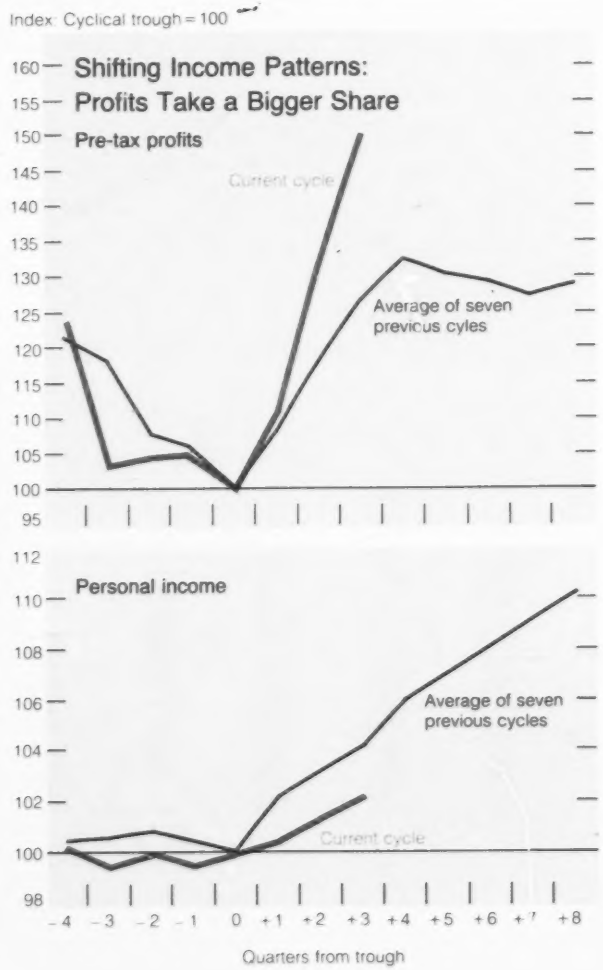


Note: Figures relate to the private nonfarm economy. Inflation is measured by the GNP deflator. The 1983 figures are estimated from three quarters of data.

*Home buyers have been showing a tendency to shift toward use of adjustable-rate mortgages in rising interest-rate situations. Data of the Federal Home Loan Bank Board indicate that 45% of commitments made in September for future mortgage lending involved adjustable-rate mortgages, up from 30% last spring. Nationwide, the initial effective interest rate on adjustable rate mortgages is averaging about one percentage point less than on fixed-rate mortgages.

come and toward profits (accompanying chart). Profits of nonfinancial corporations, adjusted for inflation, currently represent a higher percentage of output than they have at this point in the business cycle in any other recovery since the early 1960s.

Contributing to the rebound in profitability are a number of factors. Pretax profits have been helped by the moderate uptrend in wages and by the intensive cost-cutting efforts many firms have made in the past few troubled years. After-tax profits have been helped by tax-law changes and by the fact that, as inflation has moderated, corporations are being taxed on a greatly reduced volume of inflation-induced "phantom"



earnings. The effective tax rate on the economic profits* of nonfinancial corporations is now at its lowest point in 30 years (chart on page 7).

The strong showing of profits means that corporations are positioned for a time to finance capital projects with relative ease. And the promise of attractive returns on additional spending favors investment undertakings. Capital-goods ordering has already accelerated significantly, showing more strength at this stage of the business cycle than is normal. With operating rates in industry rising in the past year to approximately 80% on average, real business investment could easily be up 9% to 10% during 1984 (fourth quarter to fourth quarter). Such an increase might well account for more than a fifth of total real growth in the economy in the coming year.

Additionally, lessened weakness in the nation's external accounts should help to keep the economy moving forward. A dramatic turnabout toward stronger exports and weaker imports does not seem to be in the offing—not with the U.S. dollar 30% higher (on a trade-weighted basis) than it was three years ago against the currencies of this country's major trading partners. But at least most of the hobbling effects on recovery that have come from the external accounts seems past.

This is important because, without external-account weakness, real GNP would have risen during 1983 by close to 8% rather than 6½%. The steep slide in U.S. exports appears to be slowing, helped by vigorous economic recovery in Canada (this country's largest trading partner), and by at least moderate recovery in a number of other industrialized countries. Moreover, the sharpest import curtailment seems over

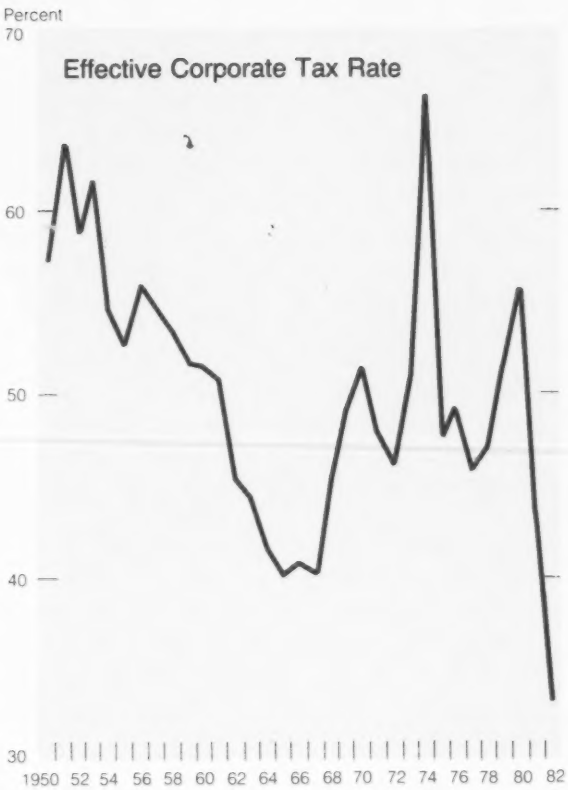
*Economic profits adjust for inventory profits caused by inflation and treat depreciation on a replacement-cost basis.

in Mexico and in some of the other troubled developing countries that trade heavily with the U.S. With moderate depreciation of the dollar (on the order of 5% to 10% by the end of 1984*), it is not unreasonable to think that, on a fourth-quarter-to-fourth-quarter basis, net exports (exports less imports) will have a neutral effect on GNP in 1984.

Finally, government spending is likely to support economic growth in the year ahead. Significantly, defense spending, in real terms, should rise by more than 6% in 1984, down only slightly from 1983. And state and local government spending, which grew modestly in 1983, is likely to provide considerably more lift for the economy. Collectively, state and local government budgets are beginning to show surpluses, due in part to the economic recovery and in part to the payoff from austerity measures adopted during the recession. Given this trend, states and localities can be expected to move ahead more aggressively in attacking the backlog of unmet infrastructure needs.

All in all, prospects for key sectors of the economy suggest a slower growth rate for real GNP during 1984, but one that at 4½% would nevertheless be slightly in excess of the average for the second year of cyclical expansion.

Inflation in 1984 is not likely to be as low as in the past year. An especially moderate increase in the price level during 1983–3¼% measured by consumer prices and 4% by the GNP deflator–was the product of factors not likely to recur: a midwinter slump in oil prices, generally well behaved food prices, and the significant strengthening in the dollar. Against that background, it would not be surprising to see a modest rise in inflation. The Morgan Bank's forecast is for both the GNP deflator and the consumer price index to advance a little less than 5% in the year ahead.



Note: Tax liabilities relative to profits excluding inventory profits and with depreciation calculated on a replacement cost basis for the domestic operations of nonfinancial corporations

Details of The Morgan Bank's 1984 forecast are shown in the table on page 2. Moderate growth ought to produce relatively stable interest rates (box on page 8).

Longer-run challenges

The year 1984 promises to be an in-between year–one when the economy will have moved out of recession but will not have fully encountered the pressures that come with high operating rates. The years 1985 and 1986, however, loom as potentially troublesome years that will test whether the discipline of recession

*A moderate dollar depreciation of this magnitude is an explicit input to The Morgan Bank's 1984 economic forecast.

INTEREST RATES IN 1984

ALTHOUGH interest rates normally trend upward in a cyclical expansion as demands on resources and on saving intensify, there are four major reasons for expecting relatively stable rates in 1984:

1. Generally satisfactory economic performance (moderate growth, declining unemployment, and relatively subdued price pressures) would probably leave the Fed disposed to continue its essentially neutralist course.

2. With the economy's demonstrated sensitivity to change in interest rates, deviations in either direction from current levels will tend to be self-limiting. As the experience last spring and summer pointed up, even moderate upward pressures on already high interest rates can diminish some of the economy's vitality—largely through slowing housing activity. That subduing effect, in turn, would ease the rate pressures themselves. And the robustness that had developed in the economy earlier this year, when rates were only slightly lower than they are now, hints that any decline in rates from prevailing levels would also be self-limiting—since demand pressure would heighten bidding for funds.

3. Worrisome as is the federal deficit problem for the longer run, there are indications that market tensions between public and private credit demands are currently at bay. In particular, the impressive improvement in profitability now under way means that corporate external financing needs (the need for funds over and above funds generated internally) will remain relatively small throughout much of 1984 (chart on page 10).

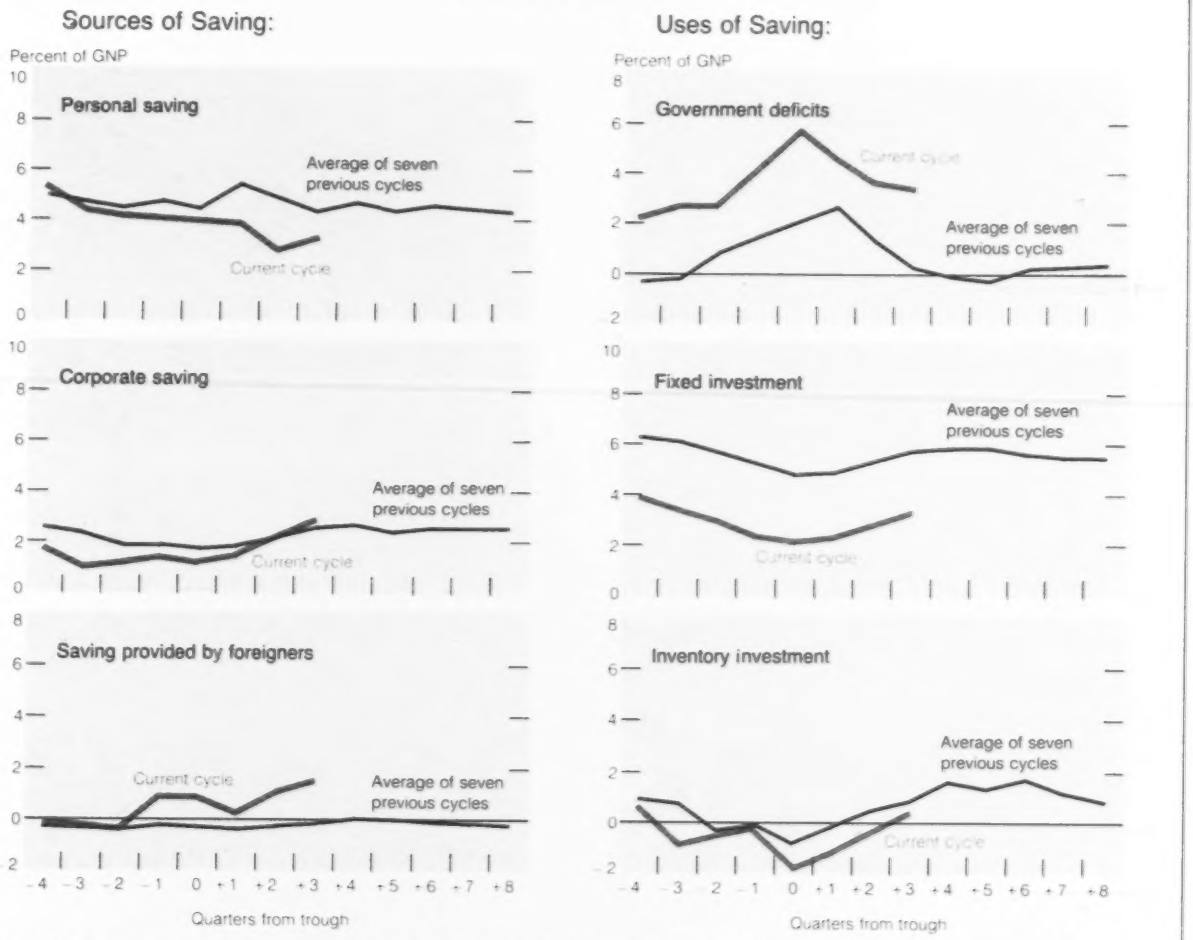
4. The fragility of the international debt situation is probably creating a disposition on the part of the Fed to limit upward interest-rate movements. This is because even marginal additions to interest burdens could be very troublesome at this stage for a number of developing countries. Indeed, higher interest rates in the U.S. would be unwelcome among developed countries as well, because of the slowness of their economies to recover and the intractability of unemployment (chart on page 15). While international-debt considerations may dispose the Fed to constrain upward pressures on rates that may develop, they probably do not give the Fed much reason to initiate interest-rate declines. As a practical matter, the Fed could not engineer enough of a decline in rates to improve debtors' positions materially. If it tried to do so, inflation expectations very likely would explode. The Fed, in short, may be capable of preventing troublesome deterioration at the margin, but it cannot hope to cure the debt difficulties of developing countries by being permissive.

(together with the various supply-side initiatives that have been legislated) has put the economy permanently on a sounder basis.

One could feel more certain of a good outcome (and less worried about a new recession developing in a year or two) if serious moves were afoot to make the federal government a smaller borrower, and a smaller user of resources, in the years stretching into the late 1980s. Because of the current fiscal stalemate, the major risk is that total public and private demand for credit, and for real resources as well, will eventually become too large to be accommodated without considerable tensions in financial markets and significant upward pressure on interest rates. It may well be possible to get through 1984 without such tensions, but it is difficult to feel confident that they can be avoided indefinitely.

Judgments about the severity of the risk are complicated not only by the difficulty involved in forecasting budget deficits but also by lack of consensus among economists on the correct theoretical framework for analyzing the prob-

The Saving Balance

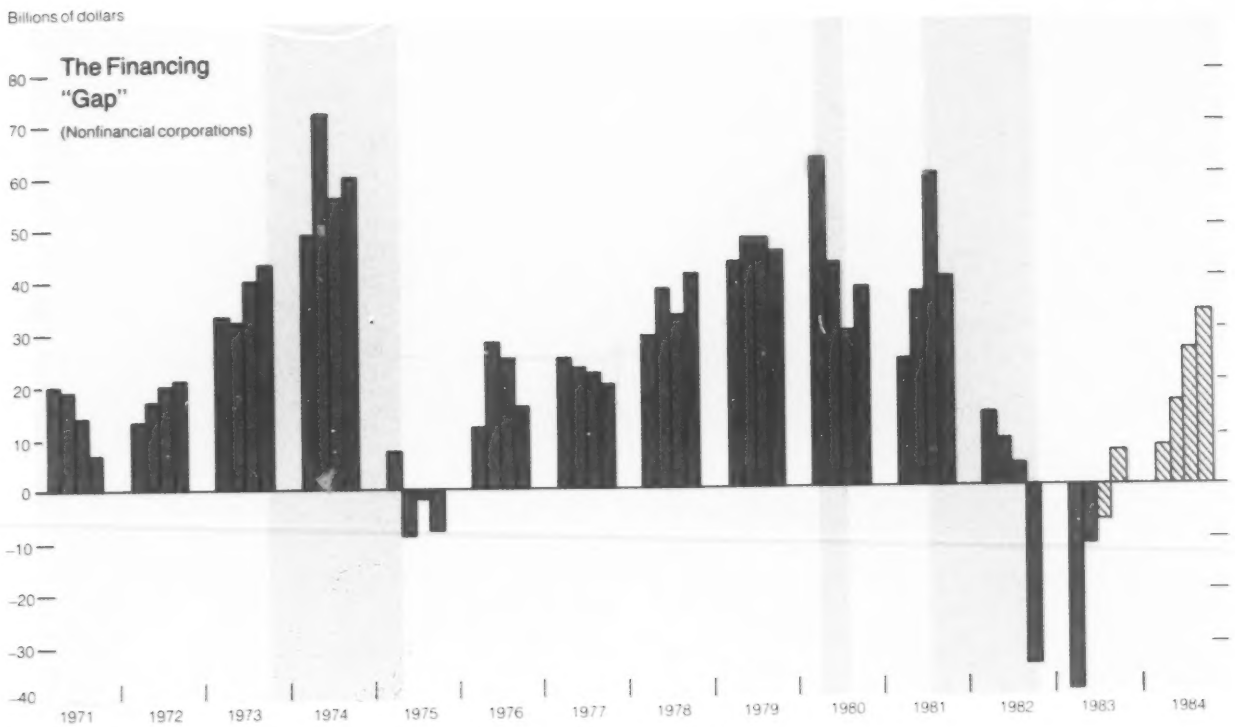


Note: All saving and investment figures are shown net of depreciation and thus represent the amount of saving and investment that is potentially available to expand the existing capital stock. If the figures were on a gross basis, that simply would lift both fixed investment and the sum of personal and corporate saving by equal amounts.

Government deficits include state and local government operating balances and accumulations in public pension plans as well as federal government deficits. If public pension plans were treated the same way as private plans, the level of budget deficits would be boosted by approximately one percent of GNP and personal saving would be boosted by the same amount. Saving provided by foreigners is essentially the mirror image of the U.S. international current account balance. Corporate saving is retained after-tax profits.

lem. Economists even differ widely on how deficits should be measured.

One way of looking at the danger posed by large deficits is by examining the way in which the economy's supply of saving (coming from individuals, corporations, and foreigners who invest here) gets allocated among various uses (inventory investment, residential construction, plant and equipment spending, and financing government deficits). The charts on this page show how savings sources and savings uses (calculated as a percent of GNP) now compare with average source-and-use patterns in past business cycles.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research.

The financing gap is the difference between corporate outlays for fixed investment and inventories and retained cash flow (depreciation plus after-tax profits minus dividends).

What stands out in the current figures is that fixed investment (residential and nonresidential) is running roughly two percentage points below what is normal for this stage of the cycle. At the same time, the government claim on saving (federal and state and local governments combined) is running roughly three percentage points higher. Personal saving has been lagging well below that of earlier years, while corporate saving has recovered very strongly. Saving provided by foreigners is unusually high, reflecting current large flows of capital to the U.S. from abroad.

The concern is that if government deficits continue at roughly 4% of GNP or higher (a likely prospect unless major deficit-reducing measures are taken by Congress) there will simply not be enough saving to restore private-sector uses of saving to the levels that are normal as economic expansion proceeds; competition for available funds would raise interest rates and curtail investment. Housing, small business undertakings, and the programs of states and localities would be disproportionately affected, and the risks of renewed recession would be high.

Even if a recession were to be avoided, a new upward interest-rate move could jeopardize the upswing in capital investment that is now under way. Cost-cutting—in response to rising imports, deregulation, and the recession—has been one key factor behind the recent productivity rebound. The underlying trend in productivity, as the table on page 11 shows, appears to have reaccelerated from the no-growth situation of the late 1970s to the range of 1.5% to 2.0% per year. Such a rate of advance is still somewhat below the 2.5% trend of the 1960s,

but the improvement that has occurred is extremely important. If the positive trend is to carry through, plant-and-equipment modernization and expansion need to continue.

Tensions in credit markets thus far have been muted by a number of factors that cannot be counted on indefinitely. The strong growth in corporate profitability, it is true, has enabled firms to finance capital programs with minimal dependence on external funds. But, as the growth in earnings settles into a more normal pattern and as business investment accelerates, firms eventually will have to turn to credit markets for funding. Also, the foreign inflows of funds which have helped to ease the pressures in credit markets that otherwise would have surfaced cannot be taken for granted on a continuing basis. If, as expected, recovery outside the U.S. gains momentum and the dollar loses some of its strength, investors abroad will bid less actively for U.S. securities and they might even reduce their holdings.

Federal Reserve officials clearly are worried —understandably so—about the potential that exists for a clash between public and private demands for credit and for real resources. The Fed, of course, could try to resist renewed upward pressure on interest rates by being accommodative in supplying reserves. If it did so, however, it would nurture inflation and reignite inflation expectations. The hard-won gains in the battle against inflation in the past few years could be lost quickly.

Monetary strategy

Given this dilemma—and the additional complication that exists because of the fragile international debt situation—it is difficult to foresee precisely how Fed policy is going to evolve from its present relatively neutralist stance to something that credibly promises renewed disinflation in the economy. Between 1979 and 1982, the Fed did have a highly credible and effective disinflation policy in place. But, by mid-1982, it was forced by the severity of the recession to abandon rigid targeting of the monetary aggregates and shifted its focus to the performance of the economy.

This shift made sense because of the major distortion in the monetary aggregates that was caused by new deposit instruments and continuing interest-rate deregulation (box on page 12). And the shift has introduced a welcome degree of flexibility into monetary policy. But the cost has been uncertainty about the Fed's resolve to

(Continued on page 14)

Productivity: Actual and Cyclically Adjusted

(Percentage change)

	Actual	*Cyclically adjusted*
1970	0.5	2.2
1971	3.3	2.8
1972	3.7	2.3
1973	2.4	2.0
1974	−2.5	−0.9
1975	2.0	3.7
1976	3.2	1.5
1977	2.3	1.4
1978	0.6	0.3
1979	−1.5	−1.2
1980	−0.7	0.8
1981	1.9	1.7
1982	0.0	2.1
1983 (proj.)	3.1	1.3
1984 (proj.)	2.3	1.7

NOTE: Productivity figures cover the private nonfarm sector of the economy.

GAUGING MONETARY POLICY: AN EXPERIMENTAL MEASURE

HAS monetary policy been "easy" or "tight" this year? Different measures give different answers.

To many, rapid growth in M1—until recently the Federal Reserve's main monetary target—is proof positive of a continuation of the easing that began in July of last year. "Real" M1 (that is, M1 adjusted for inflation) rose 9.5% between July 1982 and July 1983, following a 0.7% drop in the preceding twelve months.

But real interest rates seem to convey a different message. Measuring real rates is difficult because there are no adequate gauges of inflation expectations. But by the measure depicted in the chart, after dropping substantially from their extraordinary 1982 levels, real rates have remained high, suggesting that monetary policy has remained tight.

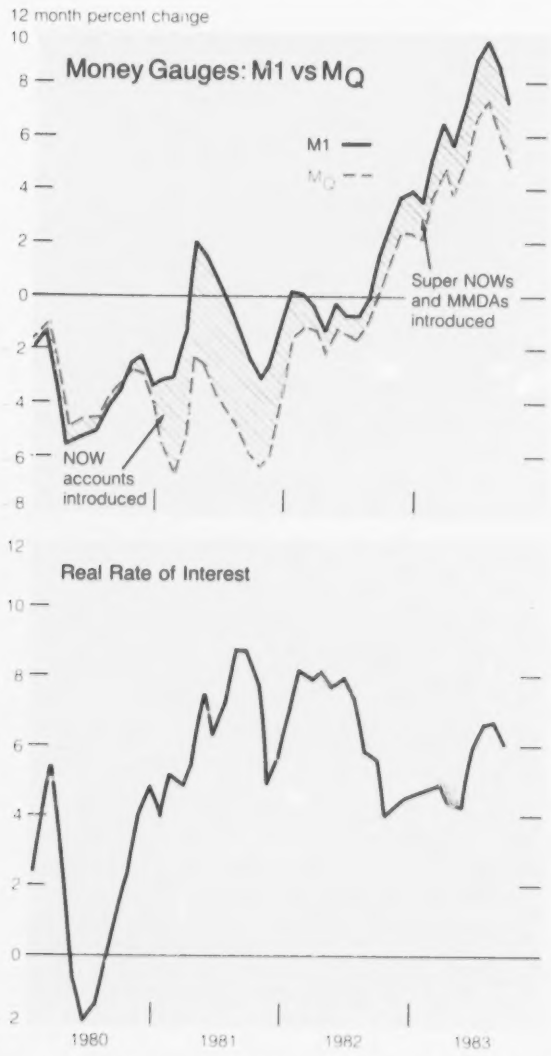
One reason for the conflicting policy interpretations is that money—like the old grey mare—just ain't what it used to be. New deposit accounts—NOWs and Super NOWs—have fundamentally altered the meaning of M1. That is because each of those new deposit vehicles lumps together funds that have savings characteristics with funds that have transactions characteristics. No longer is M1 the transactions-oriented measure that it once was. Moreover, money market deposit accounts, which also include both transactions and savings characteristics, have siphoned funds out of M1.

All this may seem like arcane economist's stuff, but it has profound implications for monetary policy. Indeed, one major reason that the Fed scuttled mechanical monetary targeting is that officials could no longer make confident judgments about the appropriateness of a given M1 growth because they were unsure of the meaning of distortions caused by the new accounts. Exactly how much transactions money were they creating?

This clearly is not a very happy state of affairs. Ideally, what is desired is a distortion-free aggregate. The search for such a measure has spawned a great deal of experimental work.

One such experiment has been undertaken by Fed economist Paul Spindt. He has attempted to identify the portion of each M1 component that is associated with purchases counted in GNP. To do that, he has studied both the patterns of cash usage and bank-debit data. The results provided the basis for estimating what portion of each component of M1 is used to acquire things other than existing assets (real or financial) and "intermediate goods" (for example, raw materials that ultimately are incorporated in a finished product). Spindt concluded that each dollar of demand deposits does roughly three times the work of each dollar of NOW balances in financing end-product GNP. Accordingly, he gave demand deposits three times as much weight as NOWs in his experimental measure of transactions money (which he dubs M_Q). He similarly weighted other components of M1 according to his estimates of their importance in financing end-product GNP.

In times of financial innovation, movements in M_Q are very different from movements in M1. As the upper panel of the chart shows, growth in real M_Q during most of the past year has been significantly lower than that of real M1. Between the fourth quarter of 1982 and July 1983, for instance, real M1 grew at a 12.5% annual clip, while real M_Q rose at a 9.8% annual rate. Had M1 grown at the slower rate over that same period, it would have been nearly $10 billion lower in nominal terms by July. That is roughly the amount of M1 growth the FOMC "forgave" last July when it rebased the 1983 target range for M1. Put another way, the growth difference between the two aggregates over that period reflects rapid expansion of the less-transactions-oriented accounts. Since July, growth in M1 and M_Q have begun to converge, as shown by the fact that the gap between them is no longer widening. That suggests that M1's ad-



Note: Money growth rates are twelve-month percentage changes adjusted for inflation.

The real rate is defined as the one-year, constant-maturity Treasury yield less the change in the personal consumption deflator over the preceding twelve-months.

justment to the new accounts may have substantially run its course.

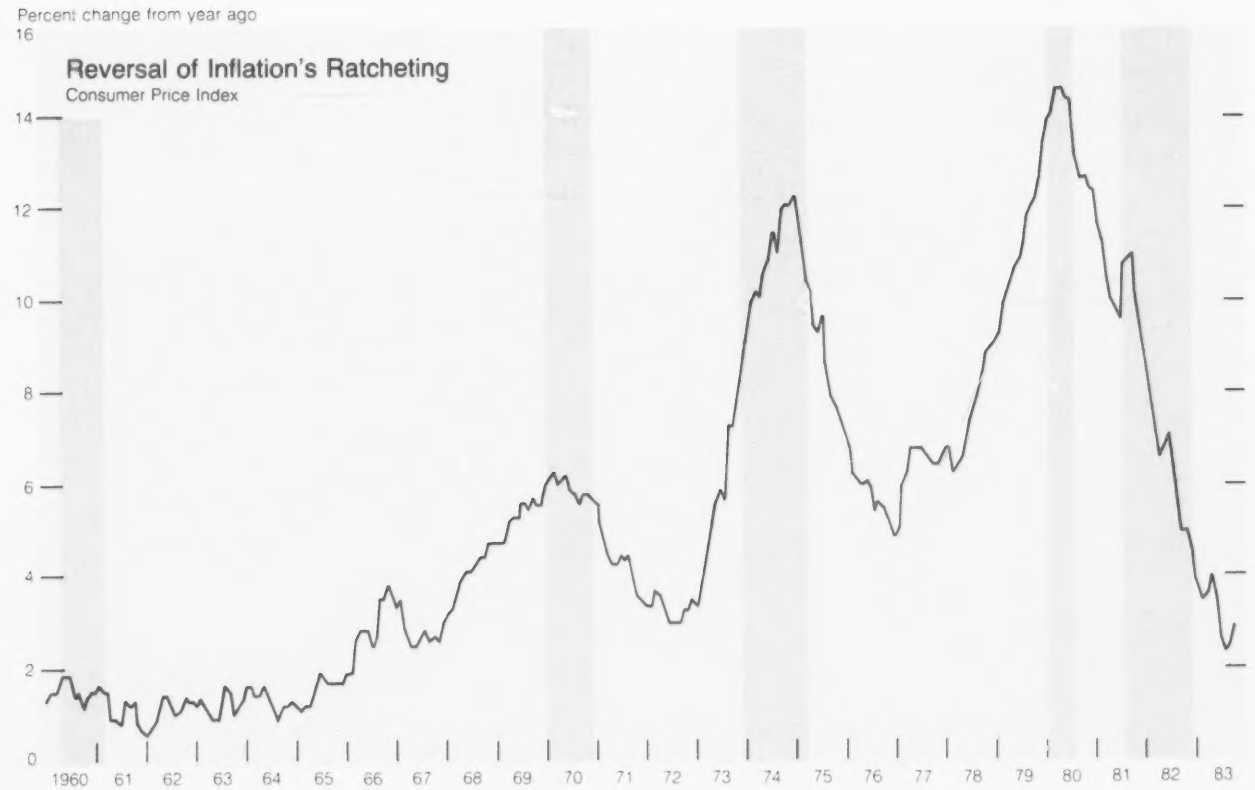
One advantage of M_Q has been its more stable and predictable velocity or "turnover rate." M1 velocity, which atypically failed to increase in the early phase of economic recovery, has risen recently. To be sure, while M1 velocity rose at a 2.2% annual rate in the third quarter, it has declined, on average, since the beginning of the recovery. Meanwhile, M_Q velocity—because it adjusts for some of the financial innovations that have recently distorted M1—has performed more as M1 velocity used to behave. In the first three quarters of the current recovery, M_Q velocity rose at a 1.3% annual rate.

The year 1983 by no means marks the first departure of M1 velocity from a relatively stable trend. In 1975-76, for example, M1 velocity soared at about twice its 3.2% trend rate of increase. And in 1980-81, M1 velocity growth became erratic, as nationwide NOW accounts were introduced. M_Q velocity, meanwhile, did not behave as erratically in either of those periods.

How good a guide?

Marked instability in the velocity of any aggregate makes it difficult for Fed officials to establish an appropriate growth rate for that aggregate. Indeed, the aberrant behavior of M1 velocity has been creating great uncertainty as to whether the tentative range established by the Fed for 1984 M1 growth is appropriate. With M1 velocity taking on a more "normal" look, that concern is lessening. However, it has not entirely evaporated, and that means that a measure such as M_Q, with a more logical conceptual grounding than M1, may have significant informational content in helping the Fed assess the appropriateness of its policy stance.

None of this is to say that M_Q should be enshrined as the perfect guide for future policy. For one thing, the estimates are still crude and need refinement. For another, in periods when deposit accounts are not changing so radically, M_Q—looked at over several quarters—will not convey signals to policymakers and Fedwatchers that are much different from those conveyed by M1. But the recent experience does point up the usefulness of looking at a statistic like M_Q in times of financial innovation.



Note: Shaded areas represent periods of recession as determined by the National Bureau of Economic Research

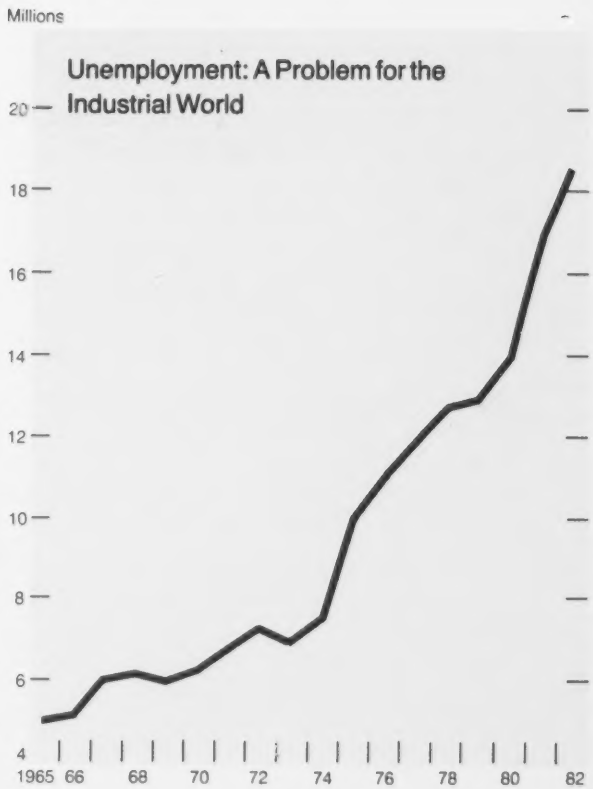
continue the anti-inflation battle. Significantly, the policy-setting Federal Open Market Committee (FOMC) is planning only moderate reductions in monetary-growth targets for 1984. And the FOMC's "central tendency" ranges for nominal GNP—which presumably represent judgments as to what FOMC members regard as acceptable—point to an expansion of 9% to 10% during 1984.

A 9%-to-10% outcome for nominal GNP next year—in line with the 1983 outcome—would be too high to be consistent with further disinflation in the economy. Neither the GNP central-tendency values nor the monetary objectives resemble the bitter price-restraining medicine administered to the economy from 1979 to 1982.

How the money-growth targets, if adhered to, will affect the economy in the coming year hinges in large part on velocity—that is, the frequency with which money balances "turn over" in financing purchases of goods and services. The behavior of velocity has been unusual lately—and no one can be confident that it is no longer a "wild card." If, for example, M1 velocity remains flat, as it has been on average this past year, then the 1984 4%-to-8% range for the growth of M1 would be restrictive. With inflation running at roughly 5%, even the upper bound of this range would sharply limit growth in real output. If, on the other hand, M1 velocity were to resume its normal 3% rate of increase, the monetary growth targets could well be very generous in the sense that nominal-GNP growth of 9% to 10% could be easily financed.

Uncertainty about velocity is a key reason, of course, why the Federal Reserve abandoned rigid money targeting in favor of a much more discretionary operating mode. Flexibility itself, however, is not a policy, and a need does exist for the Federal Reserve to give new definition to what it intends to do by way of long-term strategy. At the moment, Fed observers are left wondering what is feasible, and conviction has lessened in financial circles—and more generally—that inflation a few years ahead will be any lower than it is now. Indeed, considerable worry exists that the trough of inflation has been passed for the indefinite future—especially because monetary growth, by any measure, has been substantial during the past year. This is not a promising environment for encouraging disinflationary wage and price behavior. The FOMC's February 1984 review of its 1984 target ranges for money and its economic objectives could provide the opportunity for a restatement of intentions.

The Fed's task in reestablishing a credible disinflationary monetary policy would obviously be a great deal easier if fiscal policy were not an independent source of concern about the future. That is because fear continues to be widespread that large Treasury borrowings ultimately will provoke financial-market tensions (and force the Fed into significant debt monetization) once private credit demand revives fully.



Note: Data are for major industrial nations excluding the United States.

Those in Washington who are unwilling for whatever reasons to address the budget problem now are taking a substantial risk with the economy's longer future. With luck, trouble may not arise until the post-election period, when it may well be easier to muster support for tough measures. Counting on that, however, is hardly prudent.

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Economy Watch

THE U.S. economy continues to advance at a brisk pace, with real GNP this quarter rising at an annual rate of about 5½% (table on page 2)—unchanged from last month's estimate.

Slowing in some sectors (notably housing) has muted the especially robust growth pace of the spring and summer. Even so, recent gains in personal income, employment, and factory orders attest to strong forward momentum.

In this environment, lively Christmas spending seems assured. Inventory-to-sales ratios, already quite low in an historical context, may well drift lower. The need for restocking, in turn, could significantly influence the tempo of the economy early in 1984. Even without such a boost, the economy's pace at the turn of the year promises to be brisk enough to make an easing of monetary policy unlikely.

Christmas business surely is drawing strength not only from income gains but also from the upbeat mood of consumers. The confidence index compiled by The Conference Board, for example, reached a five-year high in November. Its rise of some 65% from the year-ago level testifies to the change in national mood since last Christmas.

The strikingly large decline in joblessness undoubtedly has been the key contributing factor. From a high of 10.8% in December of 1982, the jobless rate has continued to tumble—falling, in fact, to a surprisingly low 8.4% last month.*

The sharp decline in the unemployment rate, while surprising against year-ago expectations, is not an unprecedented development in terms

*The rates cited are based on the civilian labor force, i.e., not including in the count members of the armed forces.

of previous experience following other major postwar recessions (those, for example, that troughed in 1958 and 1975).

Behind the drop

The decline in unemployment has been roughly of the same size, measured in percentage points, as that which occurred after the 1958 business-cycle trough (shown in table below). The decline has been considerably larger, however, than that which occurred after the 1975 trough. The gain in employment has been approximately the same this time as it was then, but the labor force has grown much more slowly. Not only was the population of working age rising at a comparatively fast pace after the 1975 trough (owing to the high birth rates of the late-1950s), but participation rates also increased, due to the entry of growing numbers of women into the work force.

Now, in contrast, change in the size of the working-age population is being held back by the much reduced birth rates of the mid-1960s. And labor-force participation has declined, constraining further the growth of the labor force. The latter development doesn't seem to be related to current business conditions, nor does it seem to reflect unusual discouragement on the part of workers seeking jobs. The labor-force participation rate of men, significantly, is rising as the economy recovers. That of women seems to be stabilizing after the dramatic increases of the 1970s and early 1980s.

Unemployment in Three Recoveries

(Percent change during first year of recovery)

	Trough Month		
	April 1958	*March 1975*	*Nov. 1982*
Unemployment rate*	−2.2	−1.0	−2.3
Employment	3.2	3.2	3.5
Labor force**	1.0	2.2	0.9
Population of working age	1.4	2.0	1.1
Participation rate	−0.3	0.2	−0.3

*Change measured in percentage points.
**Based on the civilian labor force, i.e., excluding members of the armed forces.

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983	*1984*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	5.5	4.6	4.5	4.6	4.6
Real consumer spending	4.0	4.5	3.4	3.3	2.9
Real business-capital outlays	12.3	9.9	9.2	8.6	9.9
GNP deflator	4.5	4.6	4.3	4.4	4.8
Consumer prices	4.9	4.9	4.7	4.6	4.5
Real disposable personal income	6.0	2.4	2.8	3.2	3.5
Saving rate (%)	5.3	4.8	4.7	4.6	4.8
Housing starts (Millions)	1.7	1.7	1.7	1.7	1.7
Auto sales (Millions)	9.6	9.9	10.1	10.3	10.4
Unemployment rate (%)	8.5	8.3	8.1	7.9	7.8

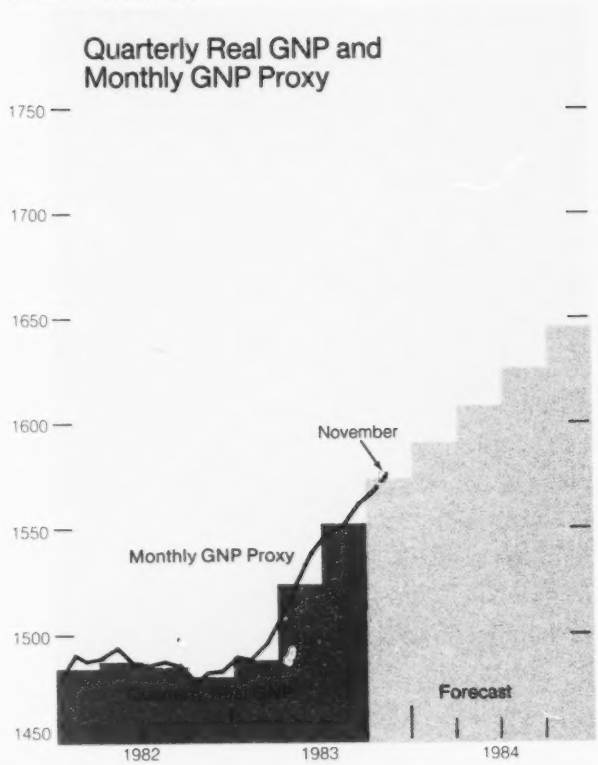
Further reductions ahead

In the coming year, a further reduction in joblessness will be harder to come by. The economy's rate of advance will be slowing—as it already seems to be—consistent with the pattern in the second year of past cyclical upswings. And that will tend to moderate the

growth of employment. Even so, a further significant reduction in joblessness, contrary to the experience in other expansions in the second year, seems to lie ahead. Again, the main reason will be the slowing in the growth of the working-age population. Unless something unforeseen happens to labor-force participation rates, November 1984 is apt to see a jobless rate just under 8%—some three percentage points below where it was only a year ago.

Such an outcome, even as recently as a month or two ago, seemed highly optimistic. The tendency was to discount the weakness in the increase of the labor force as it was reported month by month. Now, however—especially with the sharp drop in joblessness not only in November but in October as well (almost a full percentage point in the two months combined)—less skepticism about the genuineness of the decline is warranted. So, also, is more optimism warranted about what the labor markets will be reporting a year from now.

Billions of 1972 dollars



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

The Changing Mix of Business Financing

SHORT-TERM business credit* rose at an estimated 10.6% annual clip between July and October, after rising at a seasonally adjusted annual rate of only 1.3% in the first seven months of the year.

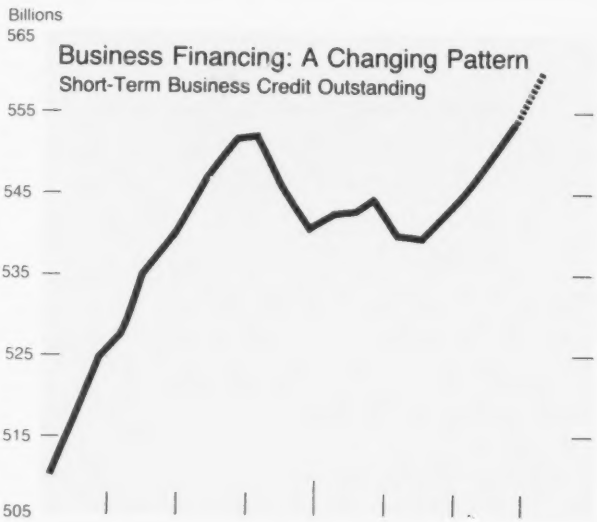
A surge in business loans by finance companies is a major reason. But even excluding that lending, short-term credit grew at a brisk 7.5%.

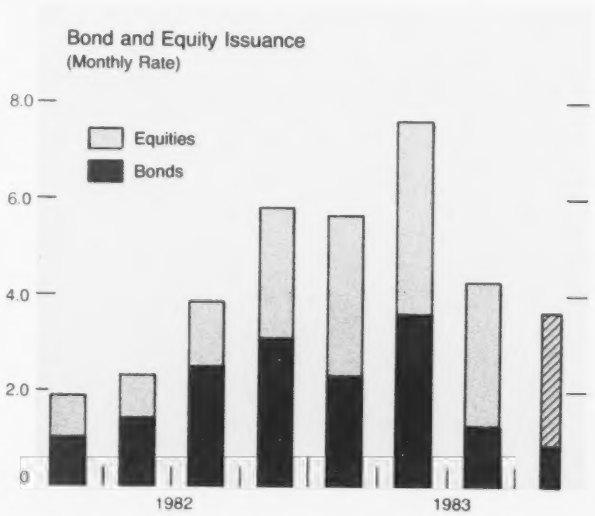
Does the sudden rise signal upward pressure on interest rates as private borrowing begins to clash with federal-credit needs? The answer appears to be: no—not yet, anyway.

A broader look at overall business financing patterns suggests that the recent pickup in short-term business-credit demands represents more a change in the composition of fund raising than an increase in the overall amount of business external financing.

While short-term business credit accelerated in the July-October period, gross issuance of long-term debt and equity by nonfinancial corporations in that period dropped to two-thirds of the rate in the first seven months (accompanying chart). For example, nonfinancial corporate bond offerings averaged $1.1 billion at a monthly rate in the three months ended in October, as compared with $2.7 billion in the January-July period. In the same span, equity issuance (including preferred stock) fell back to a $2.8 billion monthly rate from the record rate of $3.7 billion in the first seven months.

That shift in composition results, in part, from the reversal by early summer of the declines in bond rates and of the increases in share prices that had facilitated the issuance of large volumes of lower-cost debt and equity in the spring. Following the Fed's tightening in late May, and the simultaneous emergence of a stalemate over policies to reduce large prospective federal budget deficits, long-term interest rates rose by more than short-term rates. For example, double A rated corporate bond yields jumped 150 basis points by August, while one month bank





Note: Data for business credit extended by finance companies are actual through September, and estimated by The Morgan Bank for October. The plotting for bond and equity issues for the fourth quarter of 1983 is based on data for October.

*Commercial and industrial loans at all banks, loans to U.S. companies that are booked at offshore branches of U.S. banks, commercial paper issued by nonfinancial corporations, and business credit extended by finance companies.

CMOs AND MORTGAGE FINANCE

THE latest wrinkle in mortgage finance is the collateralized mortgage obligation (CMO). Introduced in June by the Federal Home Loan Mortgage Corporation, this financing vehicle has already been used to raise almost $5 billion, and more offerings are on the way.

CMOs are a new breed of mortgage-backed security. They are backed either by a specific pool of mortgages or by other mortgage-backed securities. The interest and principal of the collateral (less service and guaranty fees) are passed through by the issuer to the holder of the CMOs. Unlike other mortgage-backed securities, however, CMOs offer investors a choice of securities with different payout schedules and guaranteed minimum yields. Prepayments of principal in the underlying mortgage pool are applied to one class at a time until that class is retired.

The "slow-pay" CMOs have been especially appealing to investors interested primarily in longer-term assets. Pension funds, for example, now have greater assurance that the mortgage-backed securities they buy won't be retired too soon. This increases their ability to match asset maturities against those of their liabilities and thus reduces their exposure to changes in interest rates. On the other hand, "fast-pay," or shorter-term, CMOs have been popular with thrift institutions. They can use these new instruments more effectively than the traditional mortgage-backed securities to match the maturities of their mortgage investments with their shorter-lived deposit liabilities.

What of the future? Growth in CMOs clearly would benefit from creation of so-called Trusts for Investments in Mortgages (TIMs), but enabling legislation faces Congressional hurdles.* Nevertheless, the 25 or so offerings of CMOs now in the pipeline attest to their popularity and to their potential for widening the channel through which credit flows from capital markets to mortgage markets.

*TIMs would permit CMO issuers to remove these securities—and the assets behind them—from their balance sheets. This would enable issuers to earn a stable flow of fee income, independent of interest rate fluctuations and without reducing capital ratios, just as they now do with the standard garden-variety mortgage-backed security.

CD rates rose only three-quarters of a point. Those treasurers who got squeezed by the rise in rates had little choice but to roll over short-term liabilities.

A second reason for change in the credit composition was the replenishing of inventories in the third quarter. That was initiated by companies once it became clear that the recovery was not going to fizzle out. Although the connection between the maturity of financing instruments and the maturity of financing needs has loosened in recent years, this development seems likely to have prompted the issuance of more short-term debt. Whereas earlier in the year investment outlays were financed by a combination of strong cash flows and long-term debt and equity issuance, inventory rebuilding has probably given rise to increased dependence on shorter-term debt (such as commercial paper and loans from banks and finance firms).

Considered broadly, corporate external financing is showing the moderate rise that has been expected. Clearly, however, there has been a shift toward the use of short-term credit, which has pretty well halted the restructuring of corporate balance sheets. Ordinarily, heavier dependence on short-term funds might put profits in jeopardy, if interest rates should rise steeply. Happily, that prospect seems unlikely anytime soon.

Inflation Barometer: Rougher Weather Ahead

Economists' forecasts on inflation generally see a moderate rise ahead for 1984—in the 5%-to-6% range for the consumer price index, as against less than a 4% rise this year.

What follows is a somewhat more pessimistic view. It was written by Geoffrey H. Moore, Director, Center for International Business Cycle Research, Columbia University, and by Professor Stanley Kaish of Rutgers University.

IN a recent issue of the *Survey*,* we reported development of a new leading index of inflation. Between 1948 and 1980 the index had successfully anticipated each of the eight cyclical peaks in the inflation rate by an average of ten months and each of the eight troughs by an average of seven months.

The index is a composite of three series that reflects pressure in the commodity, financial, and labor markets. All three series have risen from their cyclical lows. Now that the upswing in the leading index has proceeded long enough and far enough to make one reasonably confident that it is cyclical and not just a blip, we can consider what it implies for the inflation rate.

Since the leading index has risen from its December 1982 low of 98.4 to a November 1983 reading of 112.6, or roughly 14 points, we may surmise that if past relationships are maintained, the inflation rate will rise about five percentage points from its trough level of about 2% in March 1983. Hence the increase in the leading index to date is pointing to an inflation rate of around 7%. By October it had already risen to 4%.

In one sense the 7% is a conservative estimate, since it assumes the leading index will rise no further. It seems likely that the index will indeed move higher before peaking. Expansions of the leading index since 1948 lasted 26 months on average, with only one less than a year. By November we were 11 months into the current expansion. We most likely have a way to go. If the leading index rises further, it will imply a higher level of inflation than 7% before it peaks.

A 9% peak?

In this regard, several important points are worth noting. 1) The leading index has risen more rapidly during the 11 months since its December trough than during the first 11 months of any of its previous expansions. 2) The leading index shows no regular pattern over the various cycles with regard to its rate of growth. During some it grew rapidly in the beginning; during others it grew faster at the end. 3) There is no demonstrated month-to-month correlation between the leading index and inflation—only a cycle-to-cycle correlation. These points suggest that the pressures indicated by the index will eventually manifest themselves before the expansion is over. However, they do not say that because the early months of the cycle saw big moves in the leading index, the early months of the inflation cycle will similarly see big moves in inflation. Nor do they say that the eventual rise in the inflation rate can be forecast from the first 11 months' rise in the index. Strictly speaking, what the past relationship tells us is that if the expansion in the leading index ended tomorrow, inflation would be likely to rise to the neighborhood of 7% before turning down. If the leading index were to

*"A New Inflation Barometer," *The Morgan Guaranty Survey*, July 1983.

Cyclical Changes in the Leading Inflation Index and the Inflation Rate (CPI), 1949-83

Dates of Peaks and Troughs				*Changes during Expansions*		
Leading Inflation Index		*Inflation Rate*		*Leading Index*	*Inflation Rate*	
Trough	*Peak*	*Trough*	*Peak*		*Actual*	*Estimated*
6/49	11/50	7/49	2/51	+34	+16	+14
8/52	3/53	3/53	10/53	+ 7	+ 2	+ 3
7/54	12/55	10/54	8/57	+14	+ 5	+ 6
4/58	7/59	3/59	10/59	+14	+ 2	+ 6
2/61	1/66	6/61	10/66	+ 8	+ 3	+ 3
4/67	4/69	5/67	2/70	+11	+ 4	+ 4
11/70	3/73	6/72	9/74	+24	+10	+10
6/75	3/79	6/76	3/80	+28	+10	+11
12/82		3/83				

NOTE: Changes in the leading index are measured in index points (1967=100) between its peak and trough dates. Changes in the rate of inflation (CPI) are measured in percentage points between its peak and trough dates. The inflation rate is the six-month smoothed rate, based upon the ratio of the current month's seasonally adjusted index to the average index during the preceding twelve months, expressed at annual rate. The "estimated" change in the inflation rate is 40% of the change in the leading index, based on the average relationship during both expansions and contractions.

achieve the *average* cyclical rise of 18 points seen during the eight expansions on record, the relationship tells us that inflation would rise about seven points to a peak level around 9% annually.

There is an additional sign that the worst days of inflation are not likely to be revisited soon. One of the characteristics of the worsening inflation picture that ran from the mid 1960s to 1980 was a pattern of rising peaks and troughs. Each time inflation bottomed out it did so at a level higher than the previous trough, and then it rose to a higher peak than previously. In 1982-83 the pattern was broken. Inflation dropped below the 1976 trough of 4.9% and fell to 1.8%. In order for inflation to resume its ascending peak format, the leading index would have to rise more than 30 points from its recent low of 98.4 during the current expansion. Such a rise occurred only once in our chronology and that was during the Korean War. Furthermore, such a rise would put the index at a level in excess of 128, a height never reached before. Assuming that peace prevails, the outlook is for more inflation, but not as much more as we unfortunately came to expect during 1965-1980.

Oil Imports: A Temporary Upswing

IMPORTS of crude oil and refined petroleum products surged from a rate of 3½ million barrels per day (bpd) in the first quarter to 5½ million bpd in the third quarter. And every indication is that oil imports have continued to run at a comparatively high rate during the closing months of the year. But the rise does not appear to signal an end to the heartening downtrend of the late 1970s and early 1980s (chart on this page). Instead, it seems to be the result of forces that are not apt to recur.

Most important, changes in oil inventories have had a sizable effect. Stocks fell by 600,000 bpd during the first quarter—presumably as refiners and others hedged against the possibility of a major softening in international oil prices. As prices stabilized in the spring, however, the incentive for such hedging was greatly reduced. Inventories began to be rebuilt, with acquisition rates rising to 900,000 bpd during the third quarter. The 1½ million-bpd swing in stocks alone accounts for three-quarters of the rise in the rate of imports between the first and third quarters.

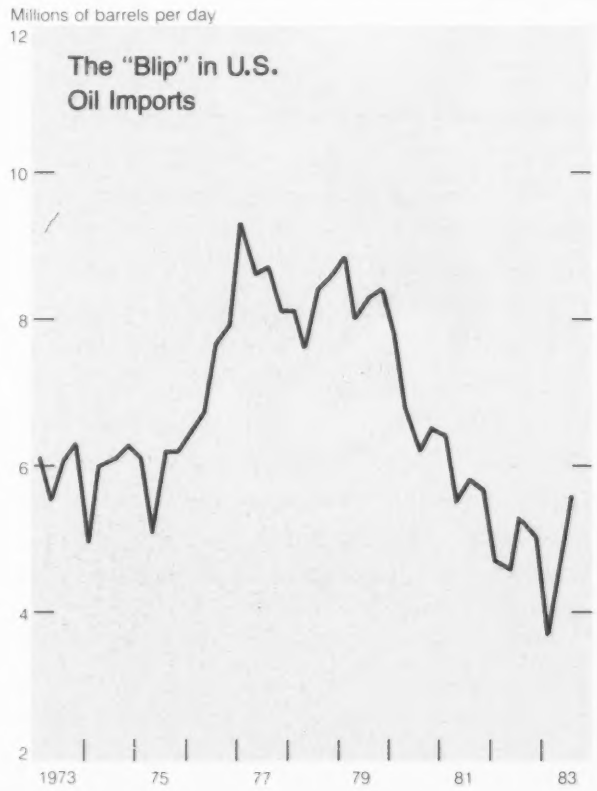
Next year, inventories are unlikely to rise significantly. The recent rebuilding has brought U.S. stocks up to near their all-time high relative to consumption. On that basis, privately held stocks (that is, not counting oil held by the federal government in the strategic Petroleum Reserve) are now about 10% higher* than they were on average in the previous 10 years. Lessened inventory building during 1984 should not only keep imports from rising further but should actually reduce them from current levels.

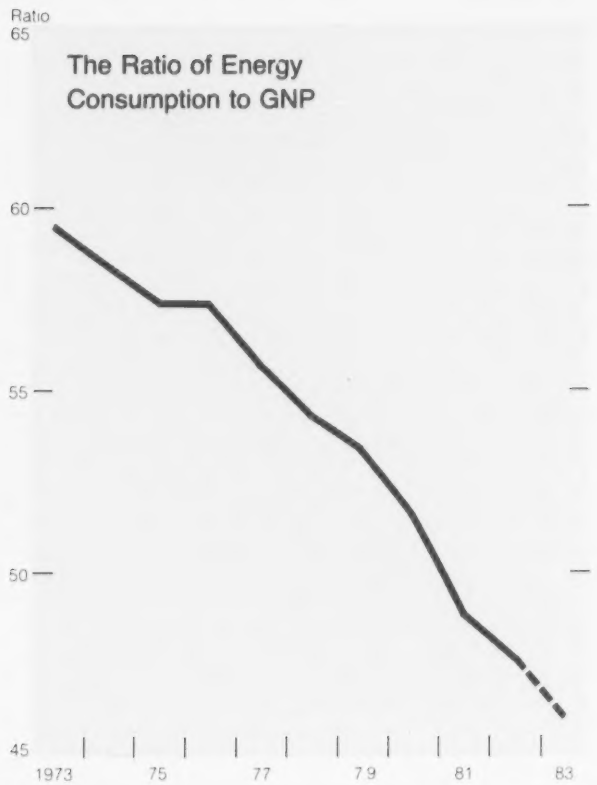
*The U.S. stands out among the countries of the International Energy Agency (IEA) in meeting the agency's goal of boosting oil inventories as a defense against supply disruptions. Including oil held in the Strategic Petroleum Reserve, stocks in the U.S. in the first seven months of this year averaged 112% of their average level during the previous 10 years. The comparable figures for the next six largest IEA members—the U.K., Germany, France, Italy, Japan, and Canada—ranged from 76% to 107%, and averaged only 90%.

Continuing the downtrend

The rapid growth in economic activity in the past year has increased demand for energy. But this source of lift for oil imports also should ease in the year ahead, in line with the moderating pace of the recovery in its second year (Economy Watch, page 1). Total energy consumption per unit of output in the U.S., which has trended downward since the mid-1970s, seems likely to continue to slip (chart at the top of page 9).

The impact of recovery has been magnified in





Note: Consumption is measured in quadrillion BTU's and GNP is measured in constant 1972 dollars.

oil markets because of the shift from natural gas to oil by industrial firms and electric utilities—a shift that may well be reversed in the year ahead. At present, the demand for oil by these fuel users—many of whom can readily adapt to either fuel—is rising from year-ago levels while their consumption of gas continues to fall. Oil usage by industry rose 1% in the three months through August, the latest available readings; usage by utilities is up 14%. Meanwhile, gas usage declined 6% in industry and 10% at utilities.

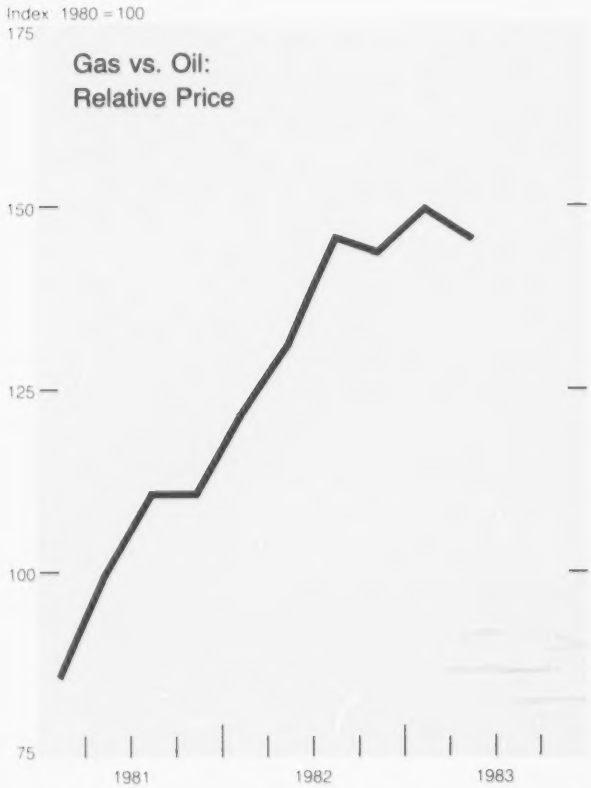
For several years, in fact, gas has lost out in both markets, reflecting in large part responses to changing relative prices.* The relative price of gas (on a comparable BTU basis) delivered to electric utilities, for example, has risen roughly 50% since 1980 (chart below).

This not only has encouraged fuel switching, but it also has caused excess capacity in the gas industry, which is now producing only about 80% of what it had been producing in the late 1970s and the early 1980s. Overcapacity, however, seems to have cut short the rise in relative gas prices, blunting the incentive of price-sensitive users to switch to oil.*

The change in natural-gas markets is likely to reduce oil imports. If, for example, only half

*This year oil is supplying an estimated 49% of the combined oil and gas needs of industry and utilities, as compared with 47% in 1981.

*Mindful of the competitive pressures, marketers of gas have been careful to hold down prices to utilities and industry. But gas prices to residential customers—who lack the ability to switch fuels easily—have continued to rise sharply.



Note: The relative price is based on the cost per BTU of natural gas delivered to electric utilities as against the cost per BTU of residual oil.

of the gas industry's overcapacity were to be absorbed, the associated increase in the consumption of gas—about 2 trillion cubic feet annually—would translate into a decline in oil imports of roughly 1 million bpd. (This assumes that production of oil in the U.S. continues to remain essentially stable.)

Considerable absorption of the industry's excess capacity would be reasonable to expect, given the efforts now being made by gas marketers to price competitively, at least to keep relative prices from rising further. Pipeline companies, for example, are pressing to renegotiate long-term contracts with producers, and in many cases they are succeeding. Added downward pressure on gas prices is coming from growing "off-system" and spot sales to utilities and industrial firms. In many cases, in fact, pipeline companies are offering gas to wholesale consumers at prices significantly below prices for residual fuel oil in order to regain market share. Even at the wellhead, constraints on pricing are evident: Prices have stabilized in the past six months after several years of increases at a rate of about 25% per year.

Staying in line

All in all, the recent surge in oil imports cannot be expected to last. Rather, imports of oil in 1984 should ease from their recent pace, quite possibly averaging between 4½ million and 5 million bpd—very much in line with the downtrend that began in the late 1970s.

The Tug-of-War Over "Float"

THE dollar value of all outstanding checks at any given time is now nearly $380 billion. At current interest rates, this "float," as it is called, is worth $36 billion a year. Small wonder, then, that hundreds of millions of dollars will be spent this year in a financial tug-of-war for these funds. Because the level of float—the amount of outstanding checks—is determined by how fast checks are presented to disbursing banks for funds, disbursers work to slow check collections in order to retain the use of the funds for as long as possible. At the same time, check collectors try to expedite the collections to obtain funds sooner.

The resources poured into the battle are only part of the cost to society. Check float hinders the development of electronic methods of payment that would increase the efficiency of the payments system. As long as disbursers can obtain float worth billions when they pay by check, they have little incentive to switch to electronic payments.

Check float can be divided into four major categories that correspond to the location of the check in the payments process: in the mail, held by the recipient, handled by the bank, and processed by the Federal Reserve.* For mail and recipient float, the time period of float is simply the time the check is in the mail or held by the recipient. For bank float, the interval is the time from receipt of the check by the bank to the time it obtains "good funds." For Fed float, the period is the interval between when the Fed passes credit to the collecting bank and when the Fed actually collects the check.

*The Fed processes checks through the 12 regional Federal Reserve Banks. A check need not generate each type of check float: many checks are not mailed or cleared through the Fed.

The value of check float is simply the product of the quantity of check float outstanding and the interest rate at which these funds could be invested (accompanying table).

Fighting for float

Businesses, individuals, and other parties that are paid by check engage in a continual struggle with their payors over mail and bank float. Collectors try to reduce mail float by locating collection points close to where the checks are mailed, and disbursers counter this tactic by mailing the checks from remote locations. To cut the level of bank float, collecting banks hire air and ground courier services to move checks through the night to meet Fed, local clearinghouse, or bank deadlines for same-day credit.

Measuring Check Float

	Billions of dollars	
	*Level**	*Value*** *(per year)*
Federal Reserve	1.3	0.12
Bank	58.0	5.51
Mail	123.3	11.71
Recipient	197.3	18.74
Total check float	**379.9**	**36.08**

*Estimates for levels of mail and recipient float are much less precise than are those for bank and Federal Reserve float. Mail and recipient float calculations start from an estimate of the dollar value of checks issued in 1983. For mail float, half of all checks are assumed to be mailed and the average mail time is assumed to equal 2.5 days. The level of mail float is then calculated: Mail float = .5 × 2.5 days/365 days × $36 trillion. For recipient float, recipients are assumed to hold checks an average of 2 days. The level can then be calculated: Recipient float = 2 days/365 days × $36 trillion.

**Calculated using a short-term interest rate of 9½%.

Disbursers make this task more difficult by locating their accounts in locations that collectors cannot easily reach—a practice known as remote disbursement.*

Unlike mail and bank float, the level of recipient float is generally determined by recipients alone because it is difficult for disbursers to influence how long recipients hold their checks. Recipients try to reduce its level by establishing lockbox operations with commercial banks. Checks delivered to a post office box are picked up by commercial banks (often in the middle of the night) to be collected as quickly as possible.

The fourth category—Fed float—is of lesser concern to collectors and disbursers. For collectors, an increase in Fed float is no longer a windfall because the collecting bank must now pay for the value of these funds (box on page 13). For the disburser, as always, the concern is when the check funds will be surrendered. The timing of when the Fed passes credit to the collecting bank is not important if the disburser need not lose use of the funds at that time.

Operational improvements have reduced Fed float to a fraction of its earlier average level—to slightly more than $1 billion today from $7 billion in 1979. Some analysts have argued that such a drop, coupled with the charges the Fed now imposes for float, will have a profound effect on the nation's payments mechanism. They claim that the end of this subsidy to check use will significantly reduce the desire to use checks.

Clearly, the end of free float lessens the incentive by removing a subsidy to check use that reached a peak of about $1.1 billion at an annual rate in December 1980. But the value of Fed float has always been dwarfed by the total value of check float. At its peak in 1979, Fed float was only about three percent of total check float. Currently, Fed float is even a smaller proportion of total check float.

The game will likely continue to be played as before. The key determinant of how hard it is played is apt to be the level of interest rates. While the end of free Fed float reduces the value of float, at current levels, by about $120 million, the dramatic fall in interest rates since 1981 has had a far greater effect. The value of check float has fallen to $36 billion—half its peak level in 1981.

Although the value of the funds gained by winners just offsets the value of the funds lost by the losers, the game, over all, is a losing proposition because collectors and disbursers spend a lot of money to play. They incur these expenditures to improve their prospects of becoming winners in the game.

On balance, the winners are those collectors and disbursers with a sufficiently large dollar volume of checks to justify the expenditures necessary to speed or slow collection. Generally, the losers are those with small volumes of checks for whom increased efforts to expedite or impede collection are not cost-effective. For example, consumers and small businesses in, say, Nashua, New Hampshire, generally have few options to accelerate the collection of a check drawn on Grand Junction, Colorado, nor can they reasonably refuse to make payment to the lockbox location in their region even when the business headquarters is located across the country.

Impediment to electronic payments

One of the most insidious effects of check float is that it restrains the rapid development

*Some businesses disburse checks to customers located on the East Coast from West Coast banks and to West Coast customers from East Coast banks.

SINKING FED FLOAT

THE Monetary Control Act of 1980 mandated that the Fed charge fees to recover the cost of providing check clearing and other services. In addition, the Fed was directed to charge for Federal Reserve float at the Federal funds rate.*

Faced with these directives, the Fed realized that if it incorporated the charges for float in its fee structure right away, the cost of its check clearing service would not be competitive with the large commercial banks that also offered check clearing services. In 1981, charges for float would have more than doubled the cost of using the Fed's check clearing system.

Faced with this prospect, the Fed delayed charging for float until after it was able to implement a strategy to mitigate the effect float charges would have on its competitive position. The Fed strategy had three parts:

- Operational improvements to reduce the level of Fed float.
- Regulatory changes to allow presentment to banks closed in mid-week and to delay credit to collecting banks on checks drawn on certain hard-to-reach locations.
- Improvements in the quality of service through later deposit deadlines for same-day or next-day credit. (This change was accomplished by reconfiguring the check transportation system and moving check presentment times to later in the day.)

By June of this year, the Fed had reduced check float to $1.7 billion from a level of $7.4 billion in the first half of 1979. Meanwhile, the new deposit deadlines implemented early this year allowed the Fed to accelerate by one day the collection of $2 billion worth of checks daily. Thus, when the Fed started to charge for float in July, it had already made service improvements with greater value than the float charges it was imposing.

*Discussed in "Fees for Fed Float," *The Morgan Guaranty Survey*, August 1980.

of electronic methods of payment. Even when electronic payments could be executed at a lower cost, they are not always utilized because they typically do not generate any float benefits for the disburser of funds.

For disbursers, the cost of making payment by check has risen rapidly in the past few years —driven upward by the imposition of Fed check-clearing fees and the explicit, "unbundled" pricing of check services by banks. Meanwhile, technological innovation has continued to reduce the cost of electronic payments. In many applications electronic payments have become less expensive to execute than check payments. Despite this cost advantage, disbursers have been slow to embrace electronic payments because the value of the check float that is forgone when an electronic payment is made typically exceeds this operational cost savings.

A recent study that compared the cost of government check payments and electronic direct deposit payments makes this point clear. Ignoring float, the cost of check payments to the Federal government was estimated to be about 40 cents per item and the cost of direct deposit payments about 27 cents per item in 1981, a substantial savings of 13 cents per item or 33%. However, when the cost of forgone check float was added to other direct deposit costs, the cost of direct deposit payments increased to 97 cents per item, far greater than the cost of check payments.

What can be done?

Clearly, check float has a pernicious effect on

the efficiency of the payments process—fostering a significant waste of resources in the check collection business. If collectors and disbursers of payments could agree on a schedule of payment after receipt of the check—in effect an industry standard for check collection—the incentives to accelerate or impede collections would be substantially reduced. The industry standard could be set in terms of the number of days from receipt of a check before credit would be given (for example, five business days until credit could be received), or the disburser of the check could be required to pay the collector for any float that was generated. In the first case, collection could be made by the least-cost method of transportation that ensured collection that satisfied the industry standard. In the second case, the funds would tend to be collected by the most efficient methods commensurate with the value (in terms of increased liquidity or reduced risk) of obtaining the funds more quickly. In both cases, the costs expended to collect and issue checks would be significantly reduced.

The problem in reaching such a solution lies in the multilateral nature of the payments process. Negotiation between all possible pairs of collectors and disbursers to reach such a standdard is unlikely. The gain for any pair of bargainers would tend to be small relative to the costs of reaching an agreement. To date, negotiated agreements between collectors and disbursers that establish guidelines governing the transfer of funds have been the exception rather than the rule.

Needed: a collective effort

What is needed is a collective effort to establish standards that determine the timing when funds are transferred. If the float benefit of check use were eliminated in this manner, the major impediment to the widespread use of electronic payment transactions would be removed. Electronic payments offer significant advantages over check payments in terms of cost of execution, reliability, and certainty when the transfer of funds will actually occur. Although development of an acceptable standard might prove difficult, the benefits that are attainable make such an effort worthwhile.

Articles Published in The Morgan Guaranty Survey in 1983

Note: Each issue includes "Economy Watch," which presents the bank's latest economic forecast.

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- Budget Blues
- Credit Markets in 1983
- Natural Gas Deregulation

February
- The Improving Inflation Outlook
- The Impact of Lower Oil Prices
- Tapping the Home-Equity Till
- Misguided Efforts on Jobs

March
- Rising Consumer Net Worth
- Jobless Pay Strains
- Pension Guarantees: How Well are they Working?

April
- Focus on Consumption Taxes
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May
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- Oil Imports: a Temporary Upswing
- Inflation: How Much of a Speedup?
- The Tug-of-War Over "Float"

J. P. Morgan & Co. Incorporated
23 Wall Street, New York, NY 10015

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Economy Watch. *Look for another good year. Fourth quarter to fourth quarter, real GNP should rise about 5%—as against 6% in the previous year. Consumer prices, though up a bit, should climb less than 5%.* 2

Unemployment. *The drop in joblessness has been the sharpest in 30 years. What has caused the decline—and will it continue?* 3

Borrowing Outlook. *Credit growth will exceed 1983's, even though economic expansion slows. But interest rates are likely to show little change from present levels. The credit picture, sector by sector.* 7

Deposit Insurance. *Concern grows among regulators that flat-rate charges undermine financial stability. Reforms now being considered.* 12

Notice to Readers

The Morgan Guaranty Survey, which was first published in April 1921, will be discontinued with this issue.

Our decision to cease publication reflects the radical transformation which has occurred in recent years in the availability of general economic intelligence. Whereas the *Survey* only a relatively short time ago was one of a handful of publications of its kind, there now exists a multitude of weeklies and monthlies that disseminate economic information and commentary.

The Morgan Bank is planning a new publication *The Morgan Economic Quarterly* that will appear later this year. Each issue will contain an in-depth analysis and forecast of economic and financial trends. Also, as circumstances warrant, there will be articles focusing on economic policy issues and financial-service industry developments. Distribution will be restricted to Morgan clients. Clients interested in receiving the quarterly should make requests in writing to their Morgan banker.

On the occasion of this final issue, we would like to thank the many readers who over the years have communicated their appreciation of the *Survey.*

Milton W. Hudson
Head, Economic
Analysis Department

Economy Watch

THE U.S. economy has entered 1984 with strong momentum. While growth has slowed from last year's pace, prospects are bright for continued expansion.

The deceleration in activity reflects developments that are normal in the second year of an economic expansion. Although inventories are still lean, restocking will provide less of a lift in 1984 than it did in 1983. And housing activity is expected to stabilize at the current 1¾ million unit production rate.

Real GNP rose at an estimated 4½% annual rate in the fourth quarter, according to the Commerce Department's widely watched "flash" estimate. That was fully three percentage points under the previous quarter's growth rate, and well below the 6%-to-7% consensus forecast range.

Significantly, the GNP estimate masks divergent trends in the farm and nonfarm sectors. Farm output dropped sharply last year in response to the worst drought of this century and the Administration's efforts to discourage production through the Payment-In-Kind (PIK) subsidy program. That decline appears to have steepened in the fourth quarter—a peak harvest period.

Nonfarm business activity, on the other hand, continues to show considerable zip. The Morgan Bank estimates that in the fourth quarter the output of this sector expanded at an annual rate between 6% and 8%—only moderately less than the third quarter's 8½% rate. This expansion implies an underlying momentum that is clearly more than Fed officials have indicated they would tolerate over any protracted period.

Yet continued strength in nonfarm output seems likely, at least for the next few months. Auto sales perked up in December, and consumers, enjoying steady advances in real income and employment, treated retailers to the best Christmas season in recent memory. Indeed, so brisk was the sales pace at year-end that inventories have apparently risen little. They now seem low enough in relation to sales that businesses are apt to keep stepping up production until they make some progress in replenishing stocks, an outcome supported by the recent impressive surge in factory orders.

All in all, the tempo of the economy—though evidently modulating to a lower key—has solid underpinnings. The Morgan Bank's forecast (table on this page) calls for real GNP to advance about 5% between the fourth quarter of 1983 and the fourth quarter of 1984. Growth at this rate surely will permit further progress in

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983	1984			
	Q4	Q1	Q2	Q3	Q4
Real GNP	4.5	4.8	5.0	5.5	5.0
Real consumer spending	6.3	4.7	3.3	3.4	2.8
Real business-capital outlays	13.8	9.7	8.8	8.8	10.4
GNP deflator	4.0	3.9	4.3	4.7	5.1
Consumer prices	4.8	4.3	4.9	5.2	5.0
Real disposable personal income	6.1	2.8	2.4	3.1	3.5
Saving rate (%)	4.9	4.4	4.2	4.1	4.2
Housing starts (Millions)	1.7	1.7	1.7	1.7	1.7
Auto sales (Millions)	9.9	10.1	10.2	10.4	10.5
Unemployment rate (%)	8.5	8.2	8.0	7.7	7.5

paring unemployment rolls, though the decline in joblessness is not likely to match last year's extraordinary improvement (story below).

With slack in labor and capital resources diminishing, attention is turning quite naturally to price trends. Thus far, the indexes have behaved remarkably well. Last year's slump in world oil prices and an absence of upward pressures on food prices reinforced an exceptionally sharp cyclical deceleration in labor costs to produce the lowest annual inflation numbers in more than a decade.

Even though the best news on inflation probably has passed, price increases in 1984 are likely to be moderate. This year is a big one for collective bargaining, but these negotiations are not likely to result in significantly larger wage settlements (box on page 4). Energy prices, also, are unlikely to cause a problem. Oil demand by industrialized countries other than the U.S. has been held back by the sluggish pace of world economic recovery. And, since oil markets require payment in dollars, the persistent strength in the dollar has boosted the cost of oil for foreign buyers. In the food sector, larger price increases are in store, reflecting the effects both of last year's drought on meat supplies and of the recent freeze on fruit and vegetable prices. The probable net result: a moderate pickup in inflation relative to 1983—to 4.8% in the consumer price index from 3.3% last year.

Despite the slowing in economic expansion, both businesses and households are apt to turn increasingly to credit markets in 1984 to finance their expenditures. That will occur at a time when borrowing by the U.S. Treasury is setting new records (story on page 7). In this environment, and with the Federal Reserve anxious to regulate the pace of economic expansion, it is difficult to foresee any major easing in interest rates this year.

Behind the Decline in Unemployment

ONE of the best pieces of news in the past year has been the dramatic drop in unemployment—a decline that far exceeded all expectations. When 1983 began, unemployment stood at a 40-year high of 10.7% of the civilian labor force. A year later, the rate is only slightly over 8%. The drop of 2½ percentage points during 1983 is the largest 12-month decline since the build up for the Korean War.

A major reason for the decrease in joblessness was, of course, the strong economic recovery. The increase of over 6% in real GNP and 16% in industrial production in the past year created almost 4 million jobs.

Employment growth, however, is only part of the explanation. Indeed, employment grew just as fast in previous recoveries, when unemployment failed to drop as rapidly as it did in the past year. The additional element has been a slowing in the rate of growth of the labor force.

Compared with the late 1970s—also a period of economic recovery—a much higher percentage of this past year's increase in employment went to reduce unemployment rather than to accommodate new entrants into the labor force (table on page 5). Thus, even though employment growth in the two periods was about the same, the unemployment rate in the past year

COLLECTIVE BARGAINING IN 1984

CONTRACTS that cover more than 40% of the 7.9 million workers under major collective bargaining agreements will expire in the year ahead. Despite this activity, however, 1984 is unlikely to bring a sharp escalation in wage-settlement patterns. That is partly because of the timing of the three-year collective bargaining cycle and partly because of a continuing high level of unemployment and intense competitive pressures at home and abroad.

Changed climate

There was a sharp break between 1981 and 1982 in collective bargaining settlements. For example, the average annual increase in compensation plunged from 8.3% for contracts negotiated in 1981 to less than 3% in 1982 and has held at about that level in 1983 (accompanying chart).*

Behind the deceleration were actual wage-rate declines in a number of contracts and only very modest increases in others. In addition, several important contracts (aerospace, airlines, and bus transportation) specified lower starting salaries for newly hired workers—a trend that will tend to hold down average wage-rate increases in 1984. Unit labor costs were further contained by an easing of union work rules, permitting, for example, workers to take on more than one task.

Many of the unions scheduled to renegotiate contracts this year have yet to feel these trends; they last negotiated at the peak of the cycle in 1981 and received hefty pay increases. But in 1984 such industries as railroads, shipping, and coal mining will have to face up to the wage deceleration of the past two years and the changed climate for collective bargaining. While there may be fewer outright wage cuts than during the past two years, the pattern of relatively modest wage increases and an easing in work rules should continue. Additionally, there is likely to be continued pressure for lower wage rates for "new hires."

Bargaining in the auto industry could prove more spirited than in other industries. Agreements at General Motors and Ford were negotiated in early 1982 and were some of the first contracts to reflect the slowing in wage gains. The union may try to reverse what it perceives as "give ups" and demand "get backs." The experience at Chrysler, where the union demanded and won very large wage increases (25% over three years) to reverse earlier declines, could be a precedent for such demands.

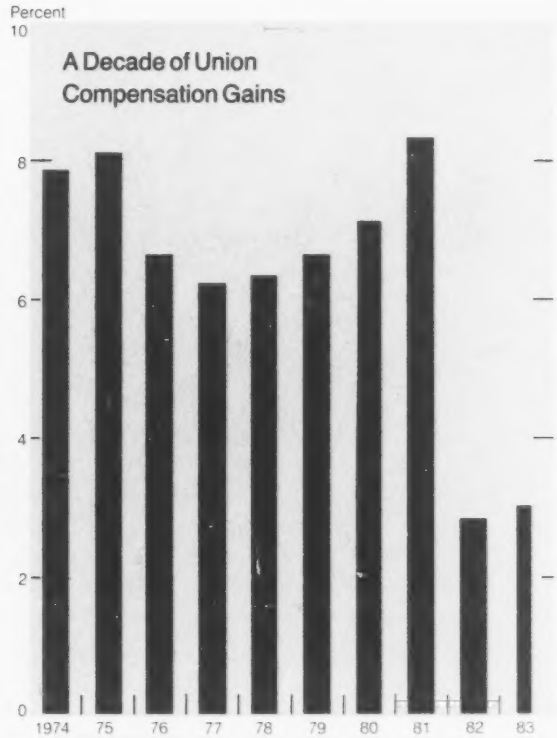
Problems in 1985?

Stiff bargaining in autos in the fall may be the precursor of tougher negotiations in 1985 and beyond.

*These figures do not include possible increases under cost-of-living clauses.

Contracts Expiring in 1984

	Industry	*Workers covered*
January	Petroleum refining	50,000
Various	Construction	1,000,000
June	Maritime	50,000
June	Railroads	300,000
Various	Food stores	300,000
July	Post office	600,000
September	Automobile	600,000
September	Bituminous coal	160,000



Note: Figures cover annual average changes in wages and benefits over the life of contracts that cover 5,000 or more workers. Figures do not include increases under cost of living clauses. Data for 1983 are for nine months.

Climbing corporate profits and a rise in the inflation rate will be cited by union bargainers as justification for higher wages and fringe benefits. Arguing against large increases, however, is the fact that the competitive pressures that played a key role in the changed settlement pattern of the past two years are still likely to be present. In particular, deregulation and new nonunion entrants will continue to provide stiff competition to established firms.

All in all, while 1984 seems likely to produce moderate wage gains and relative labor tranquillity, negotiations in 1985 and 1986 are likely to be more difficult, with an increased probability of labor unrest.

dropped almost four times more rapidly than in the earlier period.

One reason for the slowing in the growth of the labor force is the deceleration in the rate of increase of the working age population. After many years of rapid expansion, reflecting the post-World War II baby boom, the growth of the population age 16 and over slowed (table on page 6). Still, the reduced rate of population growth accounts for less than half of the deceleration in labor-force growth.

The more important, and surprising, reason for the slowing is a flattening in labor-force participation rates. During the 1970s women entered the labor force in increasing numbers, more than offsetting the slight downward trend in the participation rate of men. Higher overall participation rates during this period added a full percentage point to the rate of growth of the labor force. In the past year, the picture has changed. The rate of increase in the participation rate of women came to a virtual halt.

Obviously, employment growth depends critically on the pace of the economy. The Morgan Bank forecast (GNP growth of around 5% in 1984) implies that employment growth will slow somewhat, even though it will remain relatively

Changing Demographics

(Percent change at annual rate)

	1975 to 1979	*Dec. 1982 to Dec. 1983*
Labor force	2.9	1.1
Employment	3.7	4.0
Unemployment rate*	−0.7	−2.5

*Change in percentage points per year.

NOTE: Figures cover the civilian noninstitutional population.

Behind the Slowdown in Labor Force Growth

(Percent change at annual rate)

	1975 to 1979	*Dec. 1982 to Dec. 1983*
Labor force	2.9	1.1
Population*	1.9	1.1
Participation rate	1.0	0.0
Men**	−0.1	−0.4
Women**	2.4	0.4

*Civilian, noninstitutional population of working age.
**Age 20 and older.

rapid—quite possibly in the 2%-to-3% range.

Prospects for labor-force growth are less clear. Growth in the population of working age will remain around 1%. The major question is whether the recent slowing in the rate of increase in the participation rate of women is temporary—possibly related to the recession—or whether it represents an end to a two-decade uptrend.

It is possible that the slowing is primarily a "discouraged worker" phenomenon related to the recession. That seems unlikely, however. Women have been much less affected by the recent recession than have men. The unemployment rate for women has traditionally been approximately two percentage points higher than the rate for men (chart on this page). But in the past two years the rate for women has fallen below that for men.

One reason for this is that industries that have been especially hard hit by the recession (for example, steel, autos, and construction) have relatively few female employees. In addition, the slowdown in the growth rate of the female labor force has probably reduced competition for the types of jobs that are typically held by women.

What happens to participation rates will be a significant factor in determining the unemployment rate in the year ahead. If participation rates remain flat (as they have in the past year) and employment grows 3%, then the unemployment rate would drop below 7% at the end of this year. What seems more likely is that the labor-force participation rate will resume its growth in 1984. But even if higher participation rates added 0.5 percentage points to labor-force growth, the unemployment rate should decline, even if not as spectacularly as in the past year.

The Morgan forecast is for an unemployment rate of 7½% a year from now. Though still some distance from "full employment" (considered by most economists to represent a jobless rate of about 6%), the year ahead should bring added good news on unemployment.

Credit Markets in 1984

DESPITE a slowing in the pace of economic expansion this year, demand for credit, paced by massive Treasury needs and enlarged demands from business and consumers, will grow a bit faster than it did in 1983.

Total outstanding debt in the key nonfinancial sector (all domestic borrowers except banks and other financial institutions) will grow 10.6%, or $552 billion, this year (table on page 8).

Financial markets are likely to take such a rise in stride. But accelerating debt usage could produce some concern on the part of Federal Reserve money managers as 1984 progresses. Although the Fed does not formally target credit growth, it does have a "monitoring range" for growth in nonfinancial debt—set at 8½% to 11½% for 1983.

Last summer, Chairman Volcker announced the Fed's intent to lower that range in 1984 by half a point. Credit demands in prospect this year, thus, appear likely to crowd the top edge of the Fed's credit aggregate growth range. If borrowing does, in fact, turn out that way, the Fed may decide to keep a fairly firm grip on monetary policy—though with inflation fairly well contained and with concerns about developing nations' debt difficulties, no major stiffening seems likely. Against that backdrop, interest rates are expected to move narrowly throughout the year.

A sector-by-sector analysis of The Morgan Bank's credit projections, together with an appraisal of sources of funds:

Federal borrowing. Despite a strong economic recovery in 1983, tax reductions cut revenues and forced the Treasury to tap credit markets for an estimated $185 billion last year—nearly 15% more than in 1982. Indeed, Treasury borrowing would have been even larger had not the Administration made efforts to delay spending at the end of fiscal 1983.

The year ahead promises even larger federal borrowing. Expenditures delayed last year will show up in 1984, boosted by outlays for military hardware just now coming on stream. And, although corporate tax payments this year should surge in response to last year's rising profits, the increase will be muted by a tax law change—effective in 1983—that requires corporations to keep tax payments more current with earnings. Finally, most of the deficit-narrowing impetus from such cyclically sensitive items as transfer payments and personal income taxes (especially given last year's final installment of the personal tax cut) seems largely spent now that the economy is decelerating. The net result is that federal borrowing will likely rise another 5% or so, approaching an average of $50 billion a quarter. Such borrowings would be the highest in history.

Tax-exempt financing. Tax-exempt net borrowing in 1983—estimated at $48.3 billion—fell $2 billion short of 1982's record. But tax-exempt net borrowing includes net issuance of industrial revenue bonds (tax-exempt obligations issued on behalf of eligible corporations), which declined an estimated $5 billion from 1982. Net of those bonds, outstanding obligations of state and local governments rose $38.3 billion, eclipsing 1982's record by nearly $3 billion.

Neither state and local nor other tax-exempt borrowing is likely to set new records in 1984, however. Key reasons: Issuance in 1983 was accelerated beyond actual needs to beat a requirement that tax-exempt bonds be registered in the name of the owner (rather than in bearer form); some net issuance represented "advance

The Demand for Credit

(Billions of dollars)

	1979	*1980*	*1981*	*1982*	*1983**	*1984**	*Outstanding at year-end 1983**
Federal government issues	38.8	79.8	87.8	162.1	186.0	195.0	1173.7
Federal agency issues**	−1.3	−0.5	−0.3	−0.8	0.0	−0.1	3.4
Tax-exempt issues	30.3	30.3	21.9	50.5	48.3	42.0	472.6
Mortgages	163.4	135.0	114.4	82.9	168.2	186.0	1817.1
Corporate bonds and notes	17.3	26.6	22.1	18.8	15.0	12.0	421.0
Other business borrowing (nonfarm)	71.2	36.0	78.6	54.7	23.0	55.0	629.0
Consumer credit	45.4	4.9	24.1	18.3	42.3	45.0	473.0
All other credit	20.8	31.1	28.7	8.6	11.1	17.0	214.2
Total credit demand by domestic nonfinancial sectors	**386.0**	**343.2**	**377.2**	**395.3**	**493.9**	**552.0**	**5204.0**
Funds raised by financial sectors	82.5	63.3	85.4	69.3	77.7	86.8	764.5
Funds raised by foreigners	20.2	27.2	27.2	15.7	15.3	19.0	241.7
Total credit demand	488.7	433.7	489.8	480.3	586.9	657.8	6210.2

*Estimated. Due to rounding, components may not add to totals.
**Budget agency issues and loan participations.

refunding" of higher-cost debt; new federal restrictions on some issues will damp 1984 volume;* and a brightening fiscal picture for states and municipalities will moderate their 1984 credit needs.**

Even so, tax-exempt borrowing will remain high by historical standards. States and localities face pressing infrastructure and other needs, and the expiration of some tax increases that last year helped turn deficits to surpluses will require borrowing to finance many new projects. All in all, total net tax-exempt issuance of $42 billion—corresponding to 8.9% growth in outstanding tax-exempt debt—seems likely. In turn, the $6 billion or so decline in borrowing compared with 1983 should contribute to lower yields on tax-exempt obligations in relation to those on taxable securities.

Business financing. Nonfinancial corporations' external funding needs plunged in 1983 as the recovery and business tax cuts generated a rising tide of liquidity. Cash flow (retained earnings plus depreciation allowances) actually exceeded outlays on fixed investment and inventories by $9.3 billion last year. This comfortable cash situation reflected, in addition to the tax cuts, the biggest first-year profit surge of any postwar recovery and a massive liquidation

*One legislative proposal pending before Congress would limit the volume of "private purpose" tax-exempt issuance in each state to $150 per capita, retroactive to January 1, 1984. The uncertain status of this legislation prompted a rush to issue before year-end, even by states that had not reached this limit. In addition, statutory authority for mortgage subsidy bonds (to finance first-time, single-family home purchases) expired December 31, 1983.

**"Brightening Prospects for States and Localities," *The Morgan Guaranty Survey*, October 1983.

Sources of Funds

(Billions of dollars)

	1979	*1980*	*1981*	*1982*	*1983**	*1984**
Commercial banks	123.1	101.1	103.6	108.5	131.1	146.9
Savings institutions	56.7	54.9	27.2	30.6	113.2	125.1
Life insurance and pension funds	53.0	64.5	69.9	87.3	98.1	91.4
Money market mutual funds	19.8	14.8	62.5	21.4	−20.8	13.3
Other financial institutions	42.1	27.0	42.1	23.4	32.5	58.4
Nonfinancial corporations	5.7	−4.2	2.7	13.7	21.9	21.1
Governments, including Federal Reserve	48.2	47.3	41.2	53.3	70.0	54.1
Federally sponsored agencies and mortgage pools	53.0	45.6	48.2	65.3	70.8	57.5
Foreign investors	−4.6	23.2	16.0	17.6	18.3	25.8
Individuals and other	91.7	59.5	76.5	59.2	52.0	64.2
Total credit supply	488.7	433.7	489.8	480.3	586.9	657.8

*Estimated. Due to rounding, components may not add totals.

of inventories during the first half of the year.

More recently, however, a positive gap has reappeared, with the result that short-term credit demands have picked up noticeably. That trend is expected to continue in 1984. Corporate external financing needs should rise some $23 billion between the fourth quarter of 1983 and the fourth quarter of 1984 as profit growth slows and investment accelerates.

Following last year's pattern, the bulk of long-term financing will be accomplished in equity markets with outstanding medium- and long-term bonds rising only $12 billion—less than 3%. Corporations are expected to satisfy their remaining debt needs—estimated at $55 billion—through short-term instruments: bank loans, commercial paper, loans from finance companies, and bankers' acceptances.

Resurgent borrowing concentrated in short-term markets will interrupt the balance sheet repair that began in mid-1982, as ratios of short-term to total debt and debt to equity begin to creep up. But corporate treasurers and financial institutions, scarred by four years of slow growth and high and volatile interest rates, have recently concocted new treatments for easing balance sheet maladies. These debt-management techniques include interest rate swaps (which enable issuers of floating-rate debt to convert it to a fixed-rate liability), swaps of debt for equity, and more recently "defeasance" of debt (box on page 10). None of these remedies can immunize corporations to a dramatic rise in rates. But they do give corporate treasurers more flexibility to react quickly to financial developments.

Mortgages. Lower interest rates pumped new life into the mortgage market last year. Propelled by a revival of home buying and an influx of funds into mortgage-lending institutions, net mortgage debt formation soared in 1983 to a record $168.2 billion.

CREDIT FLOWS AND "DEFEASANCE"

MORE and more corporations are likely to "defease" debt in 1984, thanks to recent rulings by the Financial Accounting Standards Board (FASB) and the Securities Exchange Commission.* The growing popularity of defeasance could complicate the analysis of credit flows in 1984.

Defeasance allows a business firm to eliminate debt from its balance sheet by purchasing U.S. government securities and placing them in an irrevocable trust. The cash flow from the government securities must be large enough to cover interest and repayment of principal on the debt to be defeased. The debt remains an outstanding liability of the issuing company. But with the debt thus secured, the corporation is allowed to remove the obligation from its balance sheet and to recognize any gains or losses that may have occurred in the process.

Defeasance is an attractive device for a corporation that wishes to retire noncallable securities before they mature or callable, low-coupon securities that are selling below their call prices. When low-coupon issues selling at a discount are defeased, the corporation records a profit on the transaction because the cost of the government securities is less than the book value of that debt. There is no immediate tax liability, however, because the Internal Revenue Service does not consider the debt extinguished until the corporate securities mature. The effect is to provide an immediate lift for the company's earnings.

Defeasance can alter several key barometers of corporate balance-sheet health. If the corporation uses cash to buy the government securities, the ratio of debt to equity will drop as corporate debt is extinguished; the "current" ratio—current assets relative to current liabilities—also will decline. If the corporation instead borrows money to finance the transaction, both the current ratio and the ratio of long- to short-term debt will fall.

The overall impact of defeasance on credit markets is difficult to assess because defeasance is a purely financial transaction that reshuffles financial assets and liabilities. Its impact on credit flows depends upon whether the government securities are purchased with cash or by borrowing. For example, when firms borrow to purchase government securities, both the supply and demand for credit increases as the borrowing leads directly to an increase in corporate purchases of government securities.

Over all, the expected growth of defeasance activity suggests that the government securities market should be more buoyant than it otherwise would be (at the expense of nongovernment issues). Meanwhile, corporate income statements should be enhanced, while corporate liquidity will be reduced.

*This innovative financing technique was developed by The Morgan Bank in 1977. The FASB formally approved the technique last month.

This year promises to set another record for mortgage lending. Even if construction of new housing units stays at about its current 1¾ million unit level—as seems likely—moderately rising home prices and a further pickup in turnover rates for existing homes should make for a higher financing requirement. In addition, the acceleration in commercial mortgage activity begun in the third quarter of last year is likely to continue, as business investment in structures remains on the rebound. Against that background, a 1984 pickup in mortgage lending seems virtually assured. An overall total of $186 billion—a growth rate in outstandings of about 10%—is the most likely outcome.

Consumer credit. A dramatic increase in consumer credit financed much of the stronger-than-expected rise in consumption in 1983.

Taken together, installment and noninstallment credit jumped more than $42.3 billion, or nearly 10%.

Last year's borrowing and spending spree has kept the saving rate—as measured in the national income accounts—well below its 6% historical norm. This might suggest to some that consumers will soon have to rein in expenditures to keep them in line with more moderate income growth. But households can take on substantially more debt before becoming burdened by debt service. In particular, the increase in net worth over the past 18 months was so large that saving as measured by this increase actually rose relative to income. Moreover, growth rates in outstanding consumer debt have been almost matched by those of after-tax personal income. As a result, the ratio of consumer debt to personal income stands at 19.4%—well below its 1979 high of 22%. And despite rising debt, household interest payments should actually decline in relation to disposable income, as high-rate loans taken on earlier mature over the next couple of years.

In that environment, The Morgan Bank expects consumer spending to grow a little faster than disposable income during 1984. Households will continue to finance purchases—particularly of durables—through additional borrowing estimated at $45 billion.

Other credit. As the economic recovery enters its second year, credit demands by farmers and small business proprietors (included in the "all other" category in the table on page 8) should continue to rebound from 1982 lows.

That sums up demand prospects for components of the Fed's credit aggregate. But funds raised by financial institutions and foreigners are also important, inasmuch as they help satisfy nonfinancial domestic credit demands. Funds raised by financial institutions in 1983 were concentrated largely in issues of mortgage-backed and mortgage pass-through securities issued by mortgage "pools." This year, depository institutions seem likely to keep the increasingly popular variable rate mortgages on their books instead of selling them to pools as they did last year with fixed-rate mortgages. That will diminish the share of mortgages purchased by pools in 1984, and thus restrain the pools' growth. But a rising demand for loans at banks and thrifts will boost the total of financial-sector fund raising to an estimated $86.8 billion, pushing their outstanding debt up 11.4%—about the same as in 1983. Borrowing by foreigners in U.S. markets, meanwhile, is expected to rise marginally, in line with the moderate global recovery.

Sources of funds

Where will the money come from to meet these credit needs? The table on page 9 presents The Morgan Bank's estimates of the sources of funds in prospect for 1984.

Regulatory changes affecting institutional deposit gathering will exert an important influence on money flows. Thrift institutions can now bid more effectively for funds and seem likely to continue steering credit to mortgage borrowers, at least so long as their success with adjustable rate mortgages continues. Even if it does not, federally sponsored agencies will be there to continue channeling funds to home builders and buyers from investors not traditionally in the mortgage markets—either by creating new mortgage pools or via direct acquisitions.

Changing patterns of household saving will

also affect the sources of funds. Continued growth in individual retirement accounts and in "cafeteria-style" benefits packages may enable employers to negotiate smaller pension benefits. In addition, a shift to "defined-contribution" plans (as opposed to fixed-benefit coverage) seems likely to reduce the growth in pension funding. Moreover, private pension fund coffers are already bulging in relation to liabilities. As a result, corporate pension contributions could decline, reducing the volume of funds supplied by pension funds. Life insurance companies, meanwhile, will likely supply fewer funds, partly as a result of lower annuity sales which will reduce their new investable assets. In contrast, money market mutual funds—the big loser in last year's household deposit tug-of-war—have since stanched the outflow.

Widening current account deficits will be financed in part by stepped-up U.S. credit-market borrowing abroad.* Changes in U.S.-foreign interest-rate differentials—and in developments that may affect the view of the United States as a "safe haven" for investment—will influence both the strength of the dollar and the magnitude of borrowing from abroad. If, as seems likely, the dollar remains relatively strong, private foreign investors will play a stepped-up role in U.S. credit markets. And if the dollar weakens significantly, foreign central banks may step in to intervene in foreign exchange markets. That would accelerate purchases of U.S. credit-market instruments.

Other shifts in funds flows may make it harder for the federal government to finance its huge deficit. Two key sectors will be buying less Treasury debt in 1984 than they did in 1983. State and local governments, which supplied more than $23 billion to the Treasury last year as their own borrowings ran ahead of actual cash needs, will sharply curtail that financial intermediation. And commercial banks (which financed one-fourth of the federal deficit in 1983) will shift their attention to rising business, consumer, and mortgage credit demands.

The year ahead, unlike 1983, will see federal and business demands for credit rising together, while mortgage and consumer credit will remain buoyant. Although no credit surge is in prospect, the rise should be of sufficient size and strength to convince the Fed to keep the policy reins reasonably snug.

*These foreign credit flows exclude other transactions that help to finance the U.S. current-account deficit. Examples: net direct investment in the U.S.; net purchases of equities; and increases in U.S. bank and nonbank liabilities to foreigners.

Risk-Related Premiums for Deposit Insurance

THE rise in bank failures during the past two years—from an average of six a year between 1946 and 1981 to 42 in 1982 and 48 last year—has caused concern about one aspect of federal deposit insurance. Congress and regulators are worried that the flat-rate premium that depository institutions pay for insurance provokes some to take excessive risks while penalizing institutions that minimize risk-taking.

Such concerns are reflected in a recommendation made in December by the Task Group on Regulation of Financial Services, which is headed by Vice President Bush and which includes the heads of the financial regulatory agencies. It urged the development of a variable-rate premium schedule for deposit insurance. Earlier, the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank

Board (FHLBB)—the manager of the Federal Savings and Loan Insurance Corporation (FSLIC)—had advocated development of a risk-related premium structure.

Under the current deposit insurance system, a depository institution pays a flat-rate premium assessed against total deposits to insure the accounts of each depositor up to $100,000.* Because the premium rate is constant (and is assessed against total deposits rather than only insured deposits), the charge is unrelated to the potential for failure and the increased chances of losses that may have to be borne by the deposit insurance funds.

The FDIC and FHLBB have noted that this lack of linkage between the premium rate and risk has encouraged some banks and thrifts to take excessive risks.** The agencies have recognized that banks and S&Ls have incentives to try to obtain greater returns (by the use of increased leverage, by investing in more risky assets, or by mismatching the maturity distribution of assets and liabilities) because they do not have to pay a premium equal to the expected value of loss to the insurance fund. Following such a strategy, a depository institution can increase its expected rate of return by shifting a portion of the increased risk to the insurance fund. Any losses greater than the capital at risk are borne by the insurance fund and uninsured depositors.

The combination of deregulated interest rates and insurance enables an institution to attract deposits regardless of the likelihood of its failure. Insured depositors are confident that the government will protect their money even if the institution goes under. Moreover, the flat-rate premium assessment means that the cost of funds does not necessarily have to rise as the risk of failure climbs and the expected cost to the insurance fund increases.*

The problem of increased risk-taking is most apparent in the reliance of some financially shaky depository institutions on money brokers as a source of funds. An institution can obtain an almost limitless supply of funds through money brokers regardless of the institution's financial condition. Even though the money brokers are not to blame, their activities are being increasingly linked to bank and S&L failures (box on page 14).

Possible remedies

Regulators and academicians have considered a number of insurance reforms aimed at constraining depository institutions from taking excessive risks. Under one set of proposals, market discipline would be imposed by modifying deposit insurance to incorporate private insurance or coinsurance. For example, federal deposit insurance coverage might be lowered to $10,000 per account with depository institutions left free to purchase additional insurance coverage from private firms at their option. Or, following the British deposit insurance system, deposits could be only partially insured—losses would be allocated between the appropriate insurance agency and the depositor in a 75/25 split. Private insurers would presumably take

*The FDIC, the FSLIC, and the National Credit Union Share Insurance Fund (NCUSIF) all assess a regular premium equal to 1/12 of 1% of total deposits. The FDIC typically refunds a portion of that assessment, depending upon its losses and expenses, so that the cost for banks is usually somewhat smaller. In 1982, the NCUSIF assessed an additional special premium equal to 1/18 of 1% of total deposits.

**In insurance parlance, this is a problem of moral hazard. The insurance encourages risk-taking and increases the likelihood of loss.

*Of course, the existence of deposit insurance does not enable institutions to take excessive risks without consequence. Troubled institutions often will find sources of funds limited as large depositors shift their funds to less risky institutions.

MONEY BROKERS UNDER FIRE

THE FDIC and FHLBB are concerned that many of the banks and S&Ls that have failed recently have relied heavily on brokered deposits for funds. For example, the latest available data show that 26 of the 35 banks that failed during the first 10 months of 1983 relied on brokered deposits. Brokered deposits accounted for 16% of the total deposits of the 72 banks that failed between February 1982 and mid-October 1983.

In response, the FDIC and FHLBB are considering reforms that would increase reporting requirements of banks that rely on brokered deposits and slash the effective level of insurance coverage on such funds.

The two agencies are concerned that money brokers enable depositors to circumvent limits on insurance coverage and allow troubled institutions to continue to attract funds because depositors are not at risk.

Brokers enable depositors with more than $100,000—the FDIC and FSLIC limit on insured deposits at a single institution for each depositor—to obtain deposit insurance on their investment at little cost. Brokers accomplish this by breaking the investments of each client into $100,000 pieces so that a client has no more than that amount on deposit at any one institution. Because the insurance limit is placed on the owner of the deposit rather than the agent that places it, brokers can deposit millions of dollars made up of $100,000 portions with a single depository institution and still obtain deposit insurance on the entire sum. It is this capability that disturbs regulators.

Only a symptom

The activities of money brokers are only a symptom of the underlying problem—the encouragement of risk-taking provoked by the current system of deposit insurance. Even if brokered deposits were banned altogether, depository institutions could continue to obtain funds by other means, such as more widespread advertising. In fact, in the absence of money brokers, the establishment of a national newsletter to provide information to depositors on where they could obtain the highest rates would be a likely development. Depositors could then transfer funds in $100,000 increments to different depository institutions and continue to obtain federal deposit insurance for all these funds.

risk into account in their premium assessments so that there would be several different premium rates based on the risk class to which the depository institution had been assigned.

Under a second set of proposals, the current system would be retained, but the current flat-rate premium schedule would be replaced with a schedule in which the premium rate rose as the risk level increased.

Although both approaches would go a long way toward imposing market discipline, each has shortcomings. Any scheme that utilizes private insurance or coinsurance might not adequately protect the integrity of the payments system. In the case of private insurance, confidence in the banking system could weaken if depositors believed that the private insurance companies might fail. Under a system of coinsurance, widespread withdrawals could occur if depositors who would still have some funds at risk believed failure was a possibility. In addition, a private insurance system might not be viable because of adverse selection—the problem, which plagues virtually all types of insurance, of poor risks being the ones most likely to purchase insurance because they get the best

bargains. Because the institutions most interested in purchasing deposit insurance at any given premium rate would tend to be those most likely to fail, insurance companies might not be able to construct a premium schedule that allowed profitable operation.

The risk-related premium schedule scheme suffers from two flaws. First, it would be difficult, in practice, to determine an appropriate risk premium structure. Not only is the riskiness of a given portfolio difficult to evaluate, it is not apparent how steep a premium schedule would be needed to constrain the risk-taking that the insurance agencies deem unacceptable. Second, any premium schedule that included higher rates for increased risk-taking could prove to be destabilizing in practice. For example, sharply higher premium rates could encourage even greater risk-taking as institutions sought even higher yields to cover the cost of the increased deposit insurance premiums. In addition, disclosure that an institution had to pay a higher premium rate could cause depositors to withdraw uninsured funds or to demand higher interest rates. Moreover, such a premium schedule would punish all institutions that suffered a deterioration in the quality of their portfolios, regardless of the reason for the decline. In practice, the premium schedule might not always discipline the risk-taking behavior that the FDIC and FHLBB wished to discourage.

Better than the current system

Despite these shortcomings, either a private-federal insurance partnership or federal deposit insurance with risk-related premiums assessed against insured deposits would represent an improvement over the current system.

The drawbacks could be minimized by introducing some additional features. For example, if the risk of failure of private insurers were deemed to be a serious problem, the federal government could reinsure some portion of the insurance written by the private sector. Or, under a risk-related premium schedule, premiums could be set on the basis of relative performance, so that when economic downturns occurred the overall level of premiums that were assessed would not increase above some threshold. With this modification, a risk-related scheme would not increase the overall stress on the financial system during recessions.

While determining an appropriate premium schedule would not be easy, it would not be impossible. Just as drivers pay premiums for car insurance based on such characteristics as sex, age, or distance to work, so could depository institutions be assessed premiums based upon certain characteristics (such as capital adequacy, asset diversification and quality, and interest-rate risk) that are related to the likelihood of failure. As experience was gained with a risk-related premium scheme, the system could be refined.

Movement towards risk-related premiums would be a step in the right direction. Financial markets would become more efficient because the subsidy to risk-taking depository institutions would be reduced. In addition, a depository institution would begin paying for deposit insurance on a basis of how much risk of loss the institution imposed upon the deposit insurance fund. And institutions that minimized risk-taking would no longer be penalized by the fees they were assessed for insurance coverage.

J. P. Morgan & Co. Incorporated
23 Wall Street, New York, NY 10015

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